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# Voluntary Corporate Governance Disclosure, Firm Valuation, and Dividend Payout: Evidence from Hong Kong Listed Firms

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## *Abstract*

The disclosure of Corporate Governance (CG) information by firms has been found in prior studies to have an impact on the market value of firms. This thesis extends the research by studying the impact of voluntary CG disclosure by firms in Hong Kong, a market which provides a strong legal investor protection but characterized by a high insider ownership, on company valuation, as proxied by Tobin's  $q$ . This thesis also examines the role of dividend payout on the CG of Hong Kong firms.

Based on hand-collected data for a sample of 258 firm-years over the 2003-2005 period, the empirical results show that, firstly, voluntary CG disclosure is positively and significantly related to market valuation for small firms, but the relationship is not significant for large or medium firms. Combining large firms and small firms in a pooled sample, as done in most previous studies, thus misses the differential value relevance of voluntary CG disclosure for small versus large firms. Secondly, firms with higher CG disclosure are associated with lower dividend payout ratios, *ceteris paribus*. The evidence appears to suggest that CG disclosure can substitute for dividend payout. Thirdly, those small firms with medium levels of insider ownership are found to pay lower dividends than small firms with either low or very high levels of insider ownership, suggesting that investors would expect higher dividends from small firms that are prone to, or have either agency problems or entrenchment problems. Furthermore, controlling for the level of insider ownership, a small firm with high CG disclosure is always associated with a higher market valuation. The empirical evidence suggests that voluntary CG disclosure has a much stronger impact on the reduction of information asymmetry between investors (i.e., the outsiders) and managers (i.e., the insiders) for small firms than for large firms. Hence, by voluntarily disclosing more CG information, a small firm can be expected to enjoy the double benefits of receiving a higher market valuation and a lower demand for dividend payout from investors.

This study contributes to the research of value relevance of CG disclosure in several ways. It provides clear evidence that voluntary CG disclosure enhances the valuation of small firms, which previous research may have overlooked. It also shows that voluntary CG disclosure and the level of insider ownership jointly affect a firm's valuation and dividend payout. Voluntary disclosure of corporate governance information, even under a strong legal regime for investor protection, seems to be a company attribute very much appreciated by outside investors.

*To my mother,*

*Lam Yuk-Ngan,*

*who has taught me the true value of a good education*

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H.R. Lo

*Glasgow, 2009*

***Author's Declaration***

I declare that, except where explicit reference is made to the contribution of others, that this thesis is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.

Signature:

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# Chapter 1 Introduction

This thesis is an empirical study of the value relevance of the voluntary disclosure of corporate governance (CG) practices by firms in Hong Kong, a market characterized with concentrated ownership structures but with a strong legal investor-protection jurisdiction. It investigates the levels of disclosure of CG information for listed firms in Hong Kong prior to the Corporate Governance Report became a mandatory requirement in the listed firms' annual reports in 2005. The thesis also examines the market valuation of governance information disclosed in the annual reports of these firms, and specifically tests the relationship between the firms' voluntary CG disclosure and their market valuation proxied by Tobin's  $q$ . The dividend payouts of sampled firms are also analysed with respect to their voluntary CG disclosure and ownership structure, after controlling for other company-specific variables such as profitability, leverage, and sales growth.

The empirical findings of this study suggest that voluntary disclosure of CG practices has profound impact on the market valuation and dividend payout for small firms. Voluntary disclosure of CG practices appears to be useful in alleviating the concerns of outside investors for potential expropriations by the inside majority shareholders of small firms. However, the effect does not seem to be as obvious for large- or medium-sized firms, under the same level of strong investor-protection offered by the common law regime. The empirical evidence obtained from this study suggests that a firm's voluntary CG disclosure has a much stronger impact in reducing the information asymmetry between investors and managers for small firms than large firms. Hence, by voluntarily disclosing more CG information, a more transparent small firm can enjoy the double benefit of a higher market valuation and a lower demand for dividend payout. Transparency, even under a strong legal protection regime, appears to be a company attribute very much treasured by outside investors.

This chapter presents an overview of this study. Section 1.1 provides the motivation for this research, tracing its origin in appreciating the significance of CG at the firm level and at the capital market level. Section 1.2 presents a brief rationale for selecting Hong Kong listed firms as the sample for investigation (more discussion will be provided in Chapter 8). Section 1.3 introduces the key research questions, describes the methodology adopted in this research (with further elaborations in Chapter 6 and 8 respectively), and highlights

some of the implications of this study (to be discussed in detail in Chapter 11). Section 1.4 provides a summary of the organization of this study.

## 1.1 Motivation for this study

The proper functioning of a market economy, according to the Organisation for Economic Co-operation and Development (OCED), needs an effective corporate governance system to provide a degree of confidence within an individual company and across an economy as a whole (OCED, 2004, p.11). The OCED posits that the corporate governance framework should promote transparent and efficient markets (*ibid*, 2004, p. 17). Regulators of the major capital markets tend to share this view. For instance, the former chairman of the U.S. Securities and Exchange Commission has stated that capital markets require comprehensive and transparent disclosures of value-relevant information by firms in order to function efficiently. “Without it (i.e., quality information), investor confidence erodes. Liquidity dries up. Fair and efficient markets simply cease to exist” (Levitt, 1999). The Company Law Review Steering Group (CLRSG) in the U.K. regards the provision of the necessary information as the best way to facilitate effective business choices so as to maximise wealth and welfare in a market economy (CLRSG, 2000, Chp. 2, para. 2.4).

At the firm level, value-relevant information can be broadly classified into financial and non-financial. Within the non-financial information category, the disclosure of the information on corporate governance (CG) practices has become a mainstream concern. Claessens (2006) attributes this heightened interest in CG disclosure to two series of events: (i) the wave of financial crises in 1998 in the Russian Federation, Asian economies and Brazil which later endangered the stability of the global financial system; and (ii) the collapse of leading corporations in the U.S. and Europe in 2001-2002, which led to the largest insolvencies in history (e.g. Enron, WorldCom, Tyco International, Adelphia Communications, and Global Crossing). It is widely believed that these series of events are triggered by the deficiencies in the country-level CG framework or due to CG scandals at the firm level (OECD, 2004; Claessens, 2006). More understanding about the CG of a firm will help investors to protect themselves from losing their investment due to corporate failures. This is the basic motivation for this study.

Recent research suggests corporate governance (CG) disclosure is critical for the functioning of an efficient capital market (Healy and Palepu, 2001) as well as the performance of the firms (Klapper and Love, 2004). Researchers of disclosure studies assume that the insiders (i.e., managers) of a firm have superior information to the outsiders (i.e., investors) on their firm's expected future performance. To communicate their superior knowledge to investors, managers of firms choose to disclose the type and the extent of information in addition to those mandatorily required for "contracting, political, or corporate governance reasons" (Healy and Palepu, 2001, p. 420). On the other hand, investors also demand information to assess the uncertainty of current and future cash flows of their investments. Managers satisfy this demand by supplying voluntary information to enable investors to evaluate the firm value, to facilitate investors' choices of portfolio of securities, and to make other investment decisions (Meek, Roberts, and Gray, 1995).

Previous studies document that voluntary disclosures of CG information are associated with a firm's cost of equity capital (Botosan, 1997; Lombardo and Pagano, 2000); cost of debt (Sengupta, 1998); ownership structure (Lemmon and Lins, 2003); analyst coverage (Lang, Lins, and Miller, 2004); and stock performance (Gompers, Ishii, and Metrick, 2003; and Cremers and Nair, 2005). Most of them use large U.S. corporations with diffused ownership as their samples, or a cross section of sample firms from many countries with different ownership structures and various investor protection jurisdictions. To further advance the research of voluntary CG disclosure, this study aims at exploring the extent that voluntary CG disclosure would influence market valuation of a firm within a single market. Specifically, it examines the value relevance of voluntary disclosure of CG practices for firms operating under a strong legal investor protection regime but having the characteristic of a high concentration of ownership such as Hong Kong.

Strong legal protection of investors has been suggested as a central determinant of the development of financial markets (La Porta, Lopez-de-Silanes, Shleifer, and Vishny (henceforth LLSV), 2000a, 2002). It enhances investor rights such as those to receive dividends on a pro-rata basis, to vote for directors, to participate in shareholders' meetings, to elect directors or to sue them and get compensation, to stop a project that benefits the insiders at the expense of outside investors, and to liquidate the firm and receive the proceeds (LLSV, 2000a, p.5). It strengthens investor confidence in the stock market and withstands a rapid fall in asset values in a financial crisis (Johnson, Boone, Breach, and



Friedman, 2000). In those capital markets where investor protection is strong, the stock market capitalization relative to the nations' Gross Domestic Products (GDP) is higher (LLSV, 1997, 2002) and the risk-adjusted returns of firms are higher (Lombardo and Pagano, 2000).

Concentrated ownership of firms, on the other hand, is viewed as a sign of weak protection for minority shareholders (Coffee, 1999a). Through concentrated ownership, the insiders can control corporate assets, divert resources for their personal use, commit funds to unprofitable projects that provide private benefits, increase their current wealth or perquisite consumption, and expropriate outside investors by tunnelling the firm's assets and profits for the benefit of the insiders (LLSV, 2000a; Johnson, La Porta, Lopez-de-Silanes, and Shleifer, 2000). If a predominant shareholder exits (i.e., holding more than 50% of equity rights), the expropriation of outside shareholders is made even easier because the predominant shareholder, being the majority owner, can dictate the decisions of the board and control the decisions of the manager. When the predominant shareholder is also the manager of the firm, there is greater possibility for entrenchment problems to arise because minority shareholders, with lesser voting rights, are incapable of disciplining the opportunistic behaviours of managerial owner. The minority outsiders can instigate a resolution on the annual general meetings to express their dissatisfaction, but they are powerless to remove an incapable manager because the predominant shareholder can veto any resolution not to his/her liking. This study, by examining empirical evidence for firms operating in a strong legal protection regime and in an environment characterized with concentrated ownership, will shed light on the impact of voluntary disclosure of CG practices on firm's valuation.

Investors are also concerned about the returns on their investment. As suppliers of finance to corporations, investors want assurance from corporate managers that some returns will be provided to them as dividends (Shleifer and Vishny, 1997). In an environment of concentrated ownership, the controlling shareholders may implement policies that benefit themselves at the expense of minority shareholders. It is better for the minority shareholders to receive dividends than to face the risk of being expropriated by the controlling shareholders (LLSV, 2000b). As LLSV succinctly put it, "it is these minority shareholders who would typically have a taste for dividends" (LLSV, 2000b, p. 3). LLSV (2000b) point out that the dividend payout policy (i.e., how much of the earnings are paid out as dividends) has implications for the curtailment of agency problems that exist

between the insiders (i.e. the managers) and outsiders (i.e., the investors) of a firm. They argue that higher dividend payouts to the shareholders lead to lower retained earnings kept inside the firm. As a result, a higher dividend payout provides less chance for the insiders to divert profits for their personal use. To the outsiders, the disgorging of cash in terms of dividends brings more benefits than the alternative of keeping the profit as retained earnings if there is a danger of managers using the funds in pursuit of insiders' private benefits rather than maximizing shareholders' wealth.

This study also examines the relationship between a firm's corporate governance and dividend payout but from a perspective different from prior research. This study investigates if a firm's *voluntary* disclosure of corporate governance practices has impact on dividend payouts. It aims to test the arguments, as proposed by LLSV discussed above, that outside investors would prefer more dividend payout to more profits retained inside the firm in a market where strong legal investor-protection is practised but concentrated ownership prevails. From the corporate governance perspective, minority shareholders can be expected to have a preference for dividends over retained earnings. The findings of this study have particular implications for the minority shareholders: it explores how dividend policy under *concentrated ownership* can be affected by voluntary corporate governance disclosure.

Previous corporate governance (CG) research generally falls into two categories: cross-country studies and single-country studies. Cross-country studies mainly compare the impact of external CG mechanisms such as legal framework, regulatory requirements, and effectiveness of law enforcement on the performance of firms in different countries (e.g., LLSV, 1998, 2002; Claessens, Djankov, Fan, and Lang, 1999). As these researchers use leading firms in each of the countries for their studies, their sample firms are invariably confined to large, complex, corporations. On the other hand, single-country studies focus on the internal CG mechanisms of the firms within the same country while controlling for the macro-level legal and cultural environments (e.g., Haniffa and Cooke, 2002; Gompers, Ishii, and Metrick, 2003; Black, Jang, and Kim, 2006; Haniffa and Hudaib, 2006). In those studies, a blanket approach in the selection of samples is detected whereby large, medium, and small firms are pooled together into their sample frames. This study adopts a different approach in sample selection by differentiating the small firms from the large and medium firms in the sample frame. By so doing, it offers a comparison of analytical test results amongst the three samples of small-, large-and-medium-, and pooled- firms. Small-sized

firms typically receive less attention from investors and financial intermediaries such as institutional investors and analysts. They may have a bigger information asymmetry than large firms do. Botosan (1997) has already shown that firms with low analyst following exhibit a negative relationship between voluntary disclosure and their cost of capital; but similar relationship is not detected for firms that receive high attention from investors (i.e., with high analyst following). By splitting the sampling frame into three sub-samples of small firms, large-and-medium firms, and pooled-sized firms, this study will help determine whether or not firms of various sizes, characterized with concentrated ownership, would differ in their voluntary CG disclosure whilst equally subject to the strong investor-protection legal regime such as Hong Kong.

## 1.2 Rationale for using Hong Kong listed firms as sample

Hong Kong provides a unique setting for studying the effect of voluntary disclosure of CG practices in a market of strong legal protection. First, the Hong Kong stock market has always been one of the two largest capital markets in Asia (after Tokyo Stock Exchange) in terms of domestic market capitalization, only surpassed by Shanghai Stock Exchange since 2007. Unlike Shanghai Stock Exchange, Hong Kong has no foreign currencies control so that foreign investors are free from any government restrictions on effecting capital inflows in, or outflows from, the market. It also differs from the capital market in Japan where, under Japanese legislations, banks and financial institutions are legally permitted to own much greater extent in corporations (Prowse, 1992). Compared with their Japanese counterparts, Hong Kong enterprises are less reliant on banks and have fewer bank-appointed directors sitting on the corporate boards of directors than in Japan (Kaplan and Minton, 1994).

Second, Hong Kong has inherited from the U.K. a strong legal investor-protection regime based on the Anglo-Saxon common law traditions. Owner's rights and creditors' rights are well protected and the rule of law is generally upheld. Third, ownership of firms is highly concentrated in families. Corporations in Hong Kong are predominantly controlled by families (HKSA, 1997; La Porta, Lopez-de-Silanes and Shleifer, 1999; Claessens, Djankov, and Lang, 2000). Past research suggests that concentration of control in a few families creates powerful incentives and abilities to lobby government officials for preferential contracts, non-market-based financing, and may lead to crony capitalism, suppressing minority investors' rights. Fourth, in Hong Kong, controlling shareholders or related

members of their family often manage the firms they control (Claessens, Djankov, and Lang, 2000; Lins, 2003). Many family members appoint themselves as board directors and senior executives of the firms (Ho, Lam, and Sami, 2004). Separation of ownership and control in Hong Kong firms is not as clear as in the Western countries.

Finally, Hong Kong presents a cultural environment suitable for testing the voluntary disclosure of non-proprietary corporate information. Hong Kong is dominated by Chinese people who exhibit relatively high levels of collectivism and power distance, and strong uncertainty avoidance (Chow, Chau, and Gray, 1995; Chau and Gray, 2002). Societal values of high collectivism and large power distance suggest a tendency for the members of a society to adhere to rules and regulations, conform to peer norms, follow the guidance from leaders, and refrain from risk-taking due to uncertainties. Under such circumstances, firms would tend to be less transparent and disclose less information on a voluntary basis in their annual reports compared to their counterparts in the U.S. and U.K. (Chau and Gray, 2002).

In sum, Hong Kong has the following characteristics: (i) firm ownership is concentrated in founding families; (ii) directors/managers are often family members; (iii) firms generally operate with a less transparent management style due to cultural traits; and (iv) business is conducted under a strong legal investor-protection regime based on British style company law and international accounting system (Ho, Lam, and Sami, 1994; Chen and Jaggi, 2000; Ho and Wong 2001). The findings of this corporate governance disclosure research using Hong Kong firms can have significant meanings and implications for those firms operating in other markets outside the U.S., and in markets in which high concentration in family ownership is prevalent. The findings can also shed light on whether the strong legal protection regime alone, as posited by LLSV (2000a and 2000b), is good enough to protect the investors from expropriation by the majority shareholders.

Despite its cultural roots lying in Chinese society, Hong Kong followed closely the U.K. in corporate governance regulations and accounting standards before the reunion with the People Republic of China in 1997 (e.g. the publication of *Second Report of the Corporate Governance Working Group* by the HKSA, 1997). Hong Kong has subsequently been influenced by the International Accounting Standards (IAS) after 1997 (e.g. *A Guide for Directors' Business Review in the Annual Report* by the HKSA, 1998; the *Consultation Paper: Corporate Governance Review (Phase I)* by the Standing Committee on Company Law Reform (henceforth SCCLR), 2001; the *Report of Standing Committee on Company*

*Law Reform* by the SCCLR, 2003; and the *Final Recommendations from Corporate Governance Review* (Phase II) by the SCCLR, 2004). All these regulatory reforms indicate that the Hong Kong capital market is striving towards an economically international market rather than being succumbed to the influence by mainland China after the political reunion after 1997.

The Hong Kong Exchange (HKEx) and the Hong Kong Society of Accountants (HKSA) had been promoting more transparency and higher level of corporate governance disclosure since the collapses of big corporations in the U.S. and U.K in the early 2000s. They had been offering advice and consultation on CG practices to the Hong Kong listed firms. Their continuous efforts over the period 2002-2004 in encouraging the listed firms to voluntarily disclose CG practices were codified in the *Listing Rules* of HKEx (2005), which stipulates that a formal corporate governance report for the firms listed on the HKEx to be included in their annual reports starting fiscal year 2005. The change in regulations provides a unique opportunity to study the *voluntary* CG disclosure behaviour of the firms prior and up to 2005, as the listed firms had been fully informed about the contents and principles of such disclosure. It enables researchers to investigate the impact of voluntary CG disclosure on the firm valuation. Effective fiscal year 2005, the disclosure of CG information would become *compliance* with regulations for all firms.<sup>1</sup>

The analysis of this study involves an examination of 258 firms listed on the main board of Hong Kong Exchange (HKEx) between 2003 and 2005. These firms are the constituent stocks of the Hang Seng Hong Kong Composite Index (HSHKCI) and its sub-indices, which classify the firms into LargeCap, MidCap, and SmallCap firms according to the firms' market capitalization. This classification is provided, and practised, by the Hang Sang Index (HSI) Services Limited, which has been responsible for computing and reporting the indices for the Hong Kong stock market since 1969. The HSHKCI differs from the Hang Seng Index (HSI) in that the former comprises constituent stocks of listed firms domiciled in Hong Kong, whilst the latter comprises the biggest 42 stocks by market capitalization that are based in Hong Kong or mainland China. Many mainland Chinese firms are state-owned enterprises. Their ownership structures and business policies are different from those of Hong Kong based firms, and therefore may exhibit different

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<sup>1</sup> Strictly speaking, HKEx had not enforced the full CG disclosure requirements in 2005 due to opposition from listed firms on the section of internal control of the Corporate Governance Report. The HKEx agreed that firms could, if they chose to, postpone the disclosure of their internal control practices until the listed firms were prepared and ready for the setting up of their internal control system. As such, no firms were penalized within 2005 for incomplete disclosure.

degrees/ natures of agency problems (Green, 2003). Consequently, these firms of the constituent stocks of HSHKCI, all of them being Hong Kong based, are more relevant to the research objectives of this research and are used as samples in this study.

### 1.3 Research questions and research methodology

This study seeks to answer four research questions:

- (i) Prior research (as briefly discussed above and will be discussed in detail in Chapter 4) has established that voluntary disclosure of non-financial information has value relevance. Also, information on a firm's corporate governance (CG) practices helps outsiders to understand how their investments are being deployed. In such scenario, will the voluntary disclosure of CG practices by a firm affect its valuation?
- (ii) Firms vary in their sizes and complexities, which may cause variations in the information asymmetry between the insiders (i.e., the managers) and the outsiders (i.e., the investors). Would LargeCap, MidCap, and SmallCap firms behave differently in terms of voluntary CG disclosure? If so, to what extent do they differ? Will the differences, if any, affect their firm valuation, *ceteris paribus*, as well? What are the other factors that account for the differences in disclosure?
- (iii) Lemmon and Lins (2003) have shown that ownership structure plays an important role in determining the expropriation of minority shareholders (i.e., the outsiders) by the insiders in Asian economies. By making more voluntary disclosure on their CG practices, managers may reduce the outside investors' concern for potential expropriation by the majority shareholders. Firms may use voluntary CG disclosure as a signal to communicate to the outsiders to address such concern. On the other hand, because a predominant shareholder (i.e., having >50% equity holding) is often unrivalled in decision-making contests on the board of directors, one could argue that there is no point in disclosing CG information to the minority outsiders. Given the presence of a predominant shareholder, would firms still voluntarily disclose their CG? Will ownership structure be associated with the level of voluntary CG disclosure?
- (iv) La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, 2000a) argue that CG is essentially a set of mechanism through which outside investors protect themselves against expropriation by the insiders; and that the key mechanism is

the legal system which consists of investor-protection laws and their enforcement (ibid, 2000a, p. 4). LLSV also argue for the use of dividends as a means to enhance outside investor protection<sup>2</sup>. Hong Kong has a strong legal investor-protection system (LLSV, 1998), but is also characterized with high concentration of ownership. A strong legal regime may strengthen the protection of investors from insider's expropriation, but a high concentration of ownership may weaken it. Under such scenario, in what way will the outside investors balance their need for a decent return on their investment (i.e., dividend payouts) and the need for protection from insider's expropriation (as gleaned from the level of insider ownership) and other agency problems? If voluntary CG disclosure is used as a signal to the market on the state of CG practice within the firm, can voluntary CG disclosure change investors' demand on a firm's dividend payout? Can more voluntary CG disclosure substitute for dividend payout?

These are the key research questions to be answered in this thesis. They will be elaborated in more detail in Chapter 6. Based on these research questions, testable hypotheses are derived, and the arguments and rationales for formulating such hypotheses will be discussed in the same chapter.

In the course of the present study, an overview of corporate governance literature will be presented. The hypotheses and testing models developed in this study are based on previous researchers' economic theory (i.e., the agency theory by Jensen and Meckling, 1976) and models (i.e., the two agency models of dividends – the outcome model and the substitute model – by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV), 2000b). Together with the theories of voluntary disclosures developed by previous researchers (e.g., Verrecchia, 1983, 1990, 2001; Dye, 1985, 2001; Wagenhofer, 1990; Healy and Palepu, 2001; and Core, 2001), they form the theoretical framework of this study and will be discussed in the following chapters.

In terms of research methodology, a quantitative approach is adopted. Empirical data are collected from several sources. The corporate governance disclosure is measured by a score (CGDscore), which is computed and constructed from a checklist of 66 single-barrel

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<sup>2</sup> La Porta *et al* argue that, to the outsiders, dividends received is a 'bird in the hand' which is better than the retained earnings kept within the firm (which is tantamount to 'a bird in the bush') because "the latter might never materialize as future dividends (can fly away)" (LLSV, 2000b, p. 4).

questions adapted from *Appendix 23* of the *Listing Rules 2005* of the Hong Kong Exchange (HKEx). A copy of the checklist is attached in the Appendix to this study. As will be discussed in detail in Chapter 8, the CG disclosure of a firm is recorded and coded by comparing the information about the firm's CG practices as revealed in the non-financial sections of the sample firm's annual reports against the 66 questions prescribed in the checklist. Following Haniffa and Cooke (2002), a dichotomous approach is adopted in the computation of the CGDscore: an item on the checklist scores 1 if disclosed in the annual report and 0 if it is not. The score is then scaled by the total number of applicable questions relevant to the firm and expressed in terms of percentage, thus may range from zero to 100.

The market valuation of firm is measured by Chung and Pruitt's (1994) approximate  $q$ , which is an accurate approximation of Tobin's  $q$  but has the advantage of simplicity in computation. This approximate  $q$ , with adaptation, is commonly used in measuring a firm's valuation by accounting and finance researchers (e.g. Kaplan and Zingales, 1997; Gompers, Ishii, and Metrick, 2003; Cremers and Nair, 2005). Company characteristics such as the firm's profitability, dividend payout, sales growth, leverage are obtained from Datastream. Empirical data are analysed quantitatively and the relationships between the dependent variables (firm's valuation as indicated by the approximate  $q$ ; and dividend payouts) and the independent variables (CGDscore, leverage, profitability, sales growth, and other control variables) are explored mainly by ordinary least squares (OLS) multiple regressions.

The results of this study show that voluntary CG disclosure has valuation relevance, although the effect is much stronger for the small firms than for the sub-sample of pooled-sized firms. Voluntary CG disclosure can also substitute for dividend payout for firms with ownership structure susceptible to agency problems and entrenchment problems. This happens under the auspice of a strong legal investor-protection in a market where the firms' ownership structure seldom changes drastically over the short-term. The empirical results of this study demonstrate that minority investors use voluntary CG disclosure to guide their investment decisions for the firm's share valuation, and that voluntary disclosure is useful in mitigating investors' demand for dividend payout.

The findings of this study have important implications for managers, investors, regulators, as well as accounting and finance researchers. For the managers, the empirical results will clarify if the costly exercise of voluntary disclosure of CG information can help in



enhancing a firm's value. The empirical findings can affirm managers' cognition on the benefits of communication of good CG practices to the investors. To the investors, the findings of this empirical study can add to their understanding that firms of different sizes are associated with different information asymmetries between the insiders and the outsiders. Some CG practices, if disclosed voluntarily, may have different impacts on the reduction of asymmetries for different firms. Similarly, the regulators may find the empirical evidence from this study useful in assessing the prowess of voluntary disclosure; so that they may take it into consideration when they are going to determine the appropriate levels of mandatory disclosure and compliances of regulations in future for different sizes of firms. Lastly, the empirical results of this research may add contributions to the accounting and finance literature by proffering some explanations as to why previous studies have ambiguous results on the value-relevance of voluntary CG disclosure.

#### 1.4 Organization of the research study

The structure of this thesis is organized as follows. Chapter 2 provides a literature review on the theoretical frameworks of corporate governance, firm valuation, and dividend payout. A theoretical framework based on agency theory is adopted in this study. Chapter 3 explores the relationship among corporate governance, ownership structure, and firm's leverage. As Jensen and Meckling (1976) suggest, ownership structure has a close relationship with agency problems, to which corporate governance sets out to respond. This is followed by Chapter 4, which examines the inter-relationships between legal protection, corporate governance, and voluntary disclosure. LLSV (2002) emphasize that the legal protection is at the core of corporate governance. Chapter 4 thus describes LLSV's legal framework and how it is related to a firm's voluntary disclosure of corporate governance, as well as dual listing, in communicating to the outside investors. Chapter 5 describes the corporate governance development and the corporate financial reporting environment of Hong Kong. It also presents a summary of the characteristics of Hong Kong stock market and Hong Kong listed firms.

The development of hypotheses is the focus of Chapter 6, in which the assumptions and rationales for the formation of the hypotheses are presented. Chapter 7 presents the definitions and computations of the dependent variables, explanatory variables, and control variables to be tested in the empirical models in this study. The sources of information are described and the construction of the corporate governance disclosure score (CGDscore) is explained there. Chapter 8 describes the research design and explains how the sample firms are selected. It also gives the rationale on the selection of variables for this empirical study.

In Chapter 9, the descriptive statistics and the results of univariate analyses of the data are presented. Chapter 10 reports the empirical test results of the regression models, and discusses the interpretation of the results; to be followed by some robustness tests on some key models selected from the previous chapter. Chapter 11, the concluding chapter, provides a summary of the study, a discussion of the findings, and a conclusion of this thesis. It points out the limitations of this empirical study and ends by offering some suggestions for further studies into this research area.

# Chapter 2: Literature Review on Corporate Governance

## 2.1 Introduction

One of the main objectives of this thesis is to explore the relationship between voluntary disclosure of corporate governance (CG) and a firm's value. To provide a background on the research topic, this chapter reviews previous research literature on the theoretical frameworks of corporate governance. Section 2.2 introduces the various definitions of corporate governance by various research scholars, official institutions, and non-government organizations. In Section 2.3, three major theories of the CG frameworks are elaborated: agency theory, transaction cost theory, and stakeholder theory. They are the common starting point for most CG studies. Of these three theories, the agency theory will be used as the primary basis that underpins this study. Section 2.4 presents the broad classification of CG into external (i.e., macro) mechanisms and internal (i.e., micro) mechanisms. While the external mechanisms apply to all firms operating in the same country, internal mechanisms will vary from firm to firm. To the general investor, internal CG mechanisms may have more relevance than external mechanisms in assessing which firms to invest in when determining their investment portfolio, or deciding their investment strategies within the same capital market. It may be argued, therefore, that investors' knowledge about a firm's internal CG mechanisms plays a crucial role in their investment decisions. The more knowledge investors have about a firm's CG practices, the more confidence they will have about their investment decisions with regard to that firm. Section 2.5 provides a summary of the key issues in the literature review as examined in this chapter.

## 2.2 Definition of corporate governance

According to the neo-classical economists such as Alchian (1950) and Stigler (1958), product market competition is acclaimed to enable firms to achieve the optimum size based on the principles of competition and survival. Firms compete to minimize costs in order to survive. Due to this cost minimization, firms would have to adopt rules and evolutionary mechanisms to enable them to raise external capital at the lowest cost. Based on this

evolutionary theory of economic change, corporate governance has no role to play because it is subsumed by product market competition.

However, once entrepreneurs have financed the capital, the investment is often highly specific and sunk into a business endeavour. Moreover, in the practical world, entrepreneurs cannot rent the capital minute by minute. They need to be assured that they can get back the return of this sunk capital. On the one hand, product market competition may reduce the returns on capital. On the other hand, it may cut the amount that managers (i.e., agents) can possibly expropriate, but it cannot prevent the agents from expropriating the competitive return after the capital is sunk. Therefore, there is a need for some forms of corporate governance set up to provide an assurance on top of the product market competition mechanism. Indeed, corporate governance can be regarded as a set of mechanisms through which firms operate when ownership is separated from management. As Sir Adrian Cadbury of the Committee on the Financial Aspects of Corporate Governance in the U. K. puts it:

“Corporate governance is the system by which companies are directed and controlled.”

(Cadbury Committee, 1992)

Indeed, corporate governance deals with the mechanisms that provide investors in corporations with some protection in regard to their investments. Shleifer and Vishny (1997) defines corporate governance as follows:

“Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”

(Shleifer and Vishny, 1997, p. 737)

The Organisation for Economic Co-operation and Development (OECD) defines corporate governance as a set of *relationships* governing the various members of a corporation:

“Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”

(OECD Principles of Corporate Governance, 2004, p. 11)

OECD acknowledges that corporate governance is only part of the larger economic context in which firms operate. Such context includes macro-economic policies and the degree of competition in product and factor markets. The corporate governance *framework* depends on the legal, regulatory, and institutional environment as well as other factors such as business ethics and social responsibilities.

OECD also states clearly that corporate governance is affected by the relationships among participants in the governance *system* (*ibid*, 2004, p.12), and that there is no single model of good corporate governance. The Principles are evolutionary in nature. They should be reviewed in light of significant changes in circumstances. Firms must innovate and adapt their corporate governance practices to remain competitive in a changing world in order to meet new demands and grasp new opportunities (*ibid*, 2004, p.13).

Another non-government organisation, the Centre for Financial Market Integrity of the CFA Institute, defines corporate governance as a *system* of controls and procedures:

“Corporate governance is the system of internal controls and procedures by which individual companies are managed. It provides a framework that defines the rights, roles and responsibilities of different groups – management, board, controlling shareowners, and minority or non-controlling shareowners – within an organization.”

(*A Manual for Investors*, Centre for Financial Market Integrity, CFA Institute, 2005, p.7)

The Centre for Financial Market Integrity explains that corporate governance, at its core, is the arrangement of checks, balances, and incentives that a company needs to minimize the conflicting interests between insiders and external shareowners. The purpose of corporate governance is to “prevent one group from expropriating the cash flows and assets of one or more other groups” (*ibid*, 2005, p. 7).

Monks and Minow (2004) take a structural view of corporate governance. They regard CG as a *structure* within the firm and stress the importance of accountability as well as the checks and balances set in place within the firm’s management. They define corporate governance as follows:

“Corporate governance is the structure that is intended to make sure that the right questions get asked and that checks and balances are in place to make sure that the answers reflect what is best for the creation of long-term, sustainable value.”

(Monks and Minow, 2004, p. 2)

They attribute the origin of corporate governance to the separation of a firm's equity ownership from the firm's management and control:

“It is this separation between ownership and control that has been the focus of the struggles over corporate governance.”

(*ibid*, 2004, p. 111)

It can be seen from the discussion above that corporate governance can be defined in many different ways. Some researchers would like to define it according to how corporate governance is put to use. For instance, Claessens (2006) regards the definitions as falling into two categories: (i) corporate governance is concerned with a set of behavioural patterns – the actual behaviour of firms, in terms of measures such as firm performance, efficiency, growth, financial structure, and treatment of shareholders and stakeholders alike; (ii) corporate governance is concerned with the normative framework – the rules under which firms are operating, with the rules originating from the legal system, judicial system, financial markets, and factor of production (e.g., labour and product) markets. Claessens suggests that, for single country studies or within-country studies, the first type of definition is more logical. For comparative studies or cross-country analyses, the second type of definition represents a more logical choice (Claessens, 2006, p. 93). As this research examines the voluntary corporate governance disclosure of listed firms in Hong Kong, it is a single country study and will take on Claessens's first category of corporate governance definition, namely, to look upon a firm's corporate governance as a set of behaviour in terms of firm performance and treatment of shareholders and stakeholders. This study also adopts the investor-protection perspective as summarized by Rahman (2006):

“Corporate governance literature has two strands: one sees corporate governance as guiding and improving the performance of managers (Fama and Jensen, 1983b; Hart, 1995) and the other regards it as fulfilling an investor-protection function (Shleifer and Vishny, 1997).”

(Rahman, 2006, p. 362)

The second strand of corporate governance definition as described by Rahman, i.e., corporate governance is regarded as fulfilling an investor-protection function, did not receive much attention in the early days of Berle and Means (1932). However, it has attracted more and more awareness due to the work by Shleifer and Vishny (1997) and has become the centre stage of contemporary corporate governance studies since the demise of big corporations like Enron, WorldCom, Global Crossing and the like in the early 2000s.

The present study falls into this second strand of CG literature, in that it will examine corporate governance from the perspective of investor-protection by investigating the relationship between corporate governance, firm value, and dividend payout. The empirical evidence from this study will shed light on how investors seek assurance for enhancing their protection by evaluating a firm's voluntary corporate governance disclosure under a strong legal protection regime. Before moving on to the likely impact of corporate governance on firm value and dividend payout, the following section discusses in detail the origin of corporate governance and the theoretical framework for it to operate within the business context.

## 2.3 Theoretical frameworks of corporate governance: agency theory, transaction cost theory, and stakeholder theory

### 2.3.1 The information economics perspective

The issue of corporate governance evolves due to the problems arising from the separation of ownership and control of a firm's resources. In a market economy, business activities are conducted by firms. Firms are owned by shareholders (also collectively known as *the principal*) through share ownership, but are run and controlled by managers (also collectively known as *the agent*) who are paid to manage the day-to-day business of the firms. Berle and Means (1932) discussed the separation of ownership and control of large, public, corporations in the USA. They described it as a consequence of the wide dispersion of share holding and the doctrine of limited liability of the firm. Due to information asymmetry between the principal and the agent, the agency problem arises because (a) the principal and the agent have different goals, and (b) the principal cannot determine if the agent has behaved in the best interest of the principal (see Eisenhardt, 1989).

Ross (1973) explored the agency problem from the perspective of the principal: given that the agent may possess different (better or finer) information about the states of the firm than the principal, how would a principal set out to determine the agent's fee schedule at an optimal level? Since perfect monitoring of the agent's actions is difficult (though feasible) and will not be economically viable, Ross came to the conclusion that the solution to the principal's problem will not be Pareto-efficient due to a lack of perfect information.

His unresolved question opened up two different approaches in conceptualising the theory of the firm: the agency theory of the firm and the transaction economics theory of the firm, which are the subjects of discussion in the following sub-sections.

### **2.3.2 Agency theory of the firm**

Agency theory evolved from the economists' exploration of the risk-sharing problem among co-operating parties (i.e., manager and the risk-bearer) who have different attitudes towards risk and who participate in a set of bilateral contracts that facilitates efficient organisation of joint inputs in team production (Alchian, 1969; Arrow, 1970; Alchian and Demsetz, 1972). As the manager and risk-bearer have different markets for their respective services, there are alternative opportunities available to each party. For the manager, there may exist different motivations toward performance leading to opportunistic behaviour not necessarily beneficial to the risk-bearer. Viewed from this perspective, both Alchian (1969) and Alchian & Demsetz (1972) attribute the task of disciplining the manager primarily to the risk-bearer.

Jensen and Meckling (1976) formalize the concept of agency costs when they link up the agency theory with the theory of property rights and the theory of finance to develop a theory of the ownership of the firm. They describe the relationship between the principal and the agent in a contractual context and define the agency costs as the sum of (a) the monitoring expenditures by the principal, (b) the bonding expenditures by the agent, and (c) the residual loss. Furthermore, they look upon a firm as a nexus of contracts among many factors of production; each factor of production is motivated by its self-interest. They maintain that, as the manager's ownership claim falls, his incentives to search out new profitable ventures falls. Hence, the fraction of the equity held by the manager, besides the conventional classification of debt and equity, is also crucial in determining the corporate ownership structure. They state that, for a given level of inside equity owned by the manager, there exists an optimal level of debt-equity ratio that results in minimum total agency costs (Jensen and Meckling, 1976, p. 345).

Fama (1980) postulates a model to explain why the problem of separation of a firm's ownership and control can be resolved in a "set of contracts" perspective by means of a wage revision process. Fama suggests that the managerial labour market can resolve any



potential problems with managerial incentives by pricing the expected value of the manager's marginal product as the manager's wage at the beginning of the production period. In short, Fama presumes that the managerial labour market is capable of understanding fully the weight of the wage revision process.

In their theoretical paper, Grossman and Hart (1983) propose a model that analyses the principal-agent problem. The principal-agent problem they identify is that the principal is not able to monitor the agent's actions but can only observe the outcome. They break up the principal's problem into the costs and benefits accruing to the principal when the agent takes a particular action. They come up with 17 propositions and proofs and conclude that it is never optimal for the incentive scheme to be such that the principal's and agent's payoff are negatively related over the whole outcome range. They also prove that a decrease in the quality of the principal's information increases the welfare loss. Also, when there are only two outcomes, welfare loss also increases when the agent becomes more risk adverse (Grossman and Hart, 1983, p. 43).

Fama and Jensen (1983a) attribute the cause of agency problems to the fact that contracts are written and enforced at a cost. As organizations compete for survival, the form of an organization that survives is the one that delivers the product demanded by customers at the lowest price while covering costs. Fama and Jensen (1983b) develop a theory to explain why the diffusion and separation of residual risk-bearing from the decision-management has survival value in complex organizations. It is because such diffusion and separation allow valuable specific knowledge to be used at various points in the decision process where it is most relevant. It is also because the diffusion and separation help control the agency problems of diffuse residual claims.

Eisenhardt (1989) classifies Jensen, Meckling, and Fama as the positivist stream of the agency theorists. She summarizes their contributions into 2 propositions:

- (1) When the contract between the principal and agent is outcome based, the agent is more likely to behave in the interest of the principal.
- (2) When the principal has information to verify agent behaviour, the agent is more likely to behave in the interests of the principal.

In contrast with the neo-classical economic theory that tends to look upon a firm as an impersonal economic unit operating in a world of perfect markets and equilibrium, agency

theory focuses on *ex ante* incentive alignment and assumes incomplete contracts between the shareholders and the manager. It predicts that compensation policy will be designed to give the manager incentives to select and implement actions that increase shareholders' wealth. The issue of governance, therefore, is "essentially a contracting problem with *ex ante* equilibration in expected utilities" (Garvey and Swan, 1994, p. 142).

Some researchers, on the other hand, tend to regard the firm as an organization comprising people with differing views and objectives. As the firms become bigger and bigger, they become so complex that they substitute for the market in determining the allocation of resources (Solomon and Solomon, 2004, p. 21). To reduce risks and uncertainties about future prices and quality, the firm's managers have incentives to internalise transactions as much as possible. At times, these incentives may serve the managers' private interests more than are rationally warranted.

Indeed, managers do not necessarily behave rationally all the time. Rather, they practise 'bounded rationality' – the behaviour that is intentionally rational but only limitedly so (Simon, 1957) due to constraints in resources and time. This will be elaborated in the following sub-section by means of the transaction cost economics theory of the firm.

### **2.3.3 Transaction cost economics theory of the firm**

Traditional economics assume all agents to be rational and maximizing an objective function (usually profit). Transaction cost economics acknowledges that agents (or managers) as humans have a legitimate and justifiable quest for "satisficing" rather than "maximizing"– they simply cannot wait for complete information to be in place before making a perfect decision. The extent of managers' satisficing may therefore be contingent upon the circumstances which are unobservable to the firm's capital supplier. The joint result of practising bounded rationality and satisficing makes managers susceptible to *opportunism*: they organise transactions in their best interests, seeking self-interest with guile, and having a tendency to take advantage of all available means to further their own privileges (Crozier, 1964 as quoted in Solomon and Solomon, 2004, p. 22).

While some agency theorists acknowledge that the firm may be operating within the context of incomplete contracts (thus the need for mechanisms to align the interests of the principal and the agent), transaction cost economists argue that contracts cannot be well

defined *ex ante*. Hart (1995) points out that agency theory does not by itself provide a role for governance structure. It is because, by default, the optimal principal-agent contracts are “comprehensive in the sense that a contract specifies all parties’ obligations in all future states of the world, to the fullest extent” (Hart, 1995, p. 679). In such an ideal scenario, there are no residual decisions and therefore agency problems alone do not provide a rationale for corporate governance. However, when the initial contract has not specified the action to be decided in the future, governance structure will come into play. Viewed from this perspective, governance structure can be seen as a mechanism for decision-making on those issues not yet specified in the initial contract. It is a mechanism that allocates *residual rights of control* over a firm’s non-human assets. Therefore, even in a small, closely-held, firm where the number of contracts is relatively small, governance structure still remains an important issue so that all parties to the initial contract shall be kept well aware of their rights and obligations in future.

Hart (1995) also identifies three transaction costs that are particularly important: first, the cost of considering all possible eventualities that may occur during the course of the contractual relationship and of planning how to tackle them. Second, there is a negotiation cost with all the contractual parties about the plan. Third, there is a cost of putting down the plans into writing in a manner to make these plans enforceable by a third party (e.g., a court) in the event of a dispute. Hence, transaction cost economists tend to view the firm as *a governance structure*, rather than *a nexus of contracts* which provides checks and balances on managerial behaviour as suggested by Jensen and Meckling (1976).

In reality, all complex contracts are unavoidably incomplete (Williamson, 2002, p. 174). Neither can all contracts be enforced without any cost by well-informed courts (Williamson, 2005). As a result, contracting parties need to adapt to unanticipated disturbances such as gaps, errors, and omissions in the original contracts. Efforts are needed to craft governance structure within the firm, to mitigate contractual breakdowns, and to curb opportunism during the contract implementation period. The determination of an appropriate governance structure for a firm will therefore help align the interests of its shareholders and managers. The governance structure may be so designed as to impose some constraints on managers. Such constraints may comprise monitoring by (1) the board of directors, (2) large shareholders, (3) the threat of proxy fights, (4) hostile takeovers, and (5) the corporate financial structure.

While agency theory focuses on the contractual relationship between the principal (the shareholders) and the agents (the directors cum managers), it also upholds that maximization of shareholders' value is paramount via incentives offering to the agents. Transaction cost economics theory regards the firm as a governance structure and recognises that efficient governance requires more than realignment of incentives (Williamson, 1984). According to this theory, corporate governance should also cover the relationship between the firm and other stakeholders such as employees, creditors, suppliers, customers, and the community; each of which has its own different set of interests and values. Maximization of shareholders' interests over other stakeholders' interests is justifiable merely because shareholders are the recipients of the residual cash flow; that is, shareholders are the last party to be entitled to the value created by the firm, having taken into account the interests of other stakeholders. Williamson argues that "the party that bears the residual risk of the firm should reasonably expect to control the actions of the firm" (ibid, 1984, p. 1204).

In sum, transaction cost economists share more common viewpoints than differences with the agency theorists about the theory of the firm, and about the need for a system of corporate governance to regulate the relationship between two parties of a firm – the principal (i.e., investors) and the agent (i.e., the manager). In contrast, the followers of stakeholder theory consider the relationship should be covering a much broader group of parties, whom may be affected by the actions of the firm. This stakeholder theory is to be discussed in the following sub-section.

#### **2.3.4 Stakeholder theory of the firm**

Stakeholder theory argues that there are other groups to whom the firm is responsible in addition to stockholders (Freeman and Reed, 1983). Firms should pay attention to all their constituencies —employees, customers, suppliers, creditors, and communities alike — rather than stockholders alone. The word "stakeholder", originally coined by the Stanford Research Institute (SRI) in 1963, refers to "those groups without whose support the organization would cease to exist" (SRI, 1963; quoted in Freeman and Reed, 1983, p.89). The list of stakeholders originally included shareowners, employees, customers, suppliers, lenders, and society. Yet, such a definition is found to be too general and too oversimplistic to serve as a means to identify strategically important social interest groups to the firms. Freeman and Reed offer a narrower, operational definition of stakeholder as

“any identifiable group or individual on which the organization is dependent for its continued survival”. They quote examples of stakeholders as: employees, customer segments, certain suppliers, key government agencies, shareowners, certain financial institutions, as well as others (Freeman and Reed, 1983, p. 91).

Freeman and Reed (1983) recognize the influence of stakeholders on the decision-making process of a firm; hence it has implications for the board of directors. They suggest corporate directors should develop new concepts, processes, and techniques (such as the stakeholder grid) to analyse the stakeholders’ strategic impact on the firm. They posit that, at times, “stakeholders must participate in the decision-making process” (ibid, 1983, p. 95) and that the board must decide “not only whether management is managing the affairs of the corporation but indeed, what are to count as the affairs of the corporation” (ibid, 1983, p. 96). The board of directors of a firm is charged with the responsibility to deal with the stakeholder confrontation, given so many possible combinations of voting power, economic power, and political power available to various interested parties in the corporate governance realm. Their view is extended by Freeman and Evan (1990), who suggest that the firm is best conceptualised as a set of multilateral contracts among stakeholders. However, they argue that the contractual view of the firm is probably not sufficient to explain completely the development of the modern corporations. Other concepts and theories are needed to complement and strengthen the viable contract theory.

Donaldson and Preston (1995) clarify that stakeholder theory has four different aspects: the *descriptive/empirical*, *instrumental*, *normative*, and *managerial* aspects. The *descriptive/empirical* aspect refers to the function of the theory in describing what the corporation is: it is a constellation of co-operative and competitive interests possessing intrinsic value. It explains specific corporate characteristics and how firm managers actually behave. The *instrumental* aspect serves to identify the connections between stakeholder management and the achievement of traditional corporate objectives such as growth and profitability. This formulation of the theory is used to generate implications that adherence to stakeholder principles and practices will achieve conventional corporate performance objectives or even better than rival approaches. It purports to describe what will happen if firms behave in certain ways. The *normative* aspect is used to interpret the function of the corporation, including the identification of moral or philosophical guidelines for the corporation’s management. An example of the normative aspect is the concept of corporate social responsibility which essentially states: “Do (Don’t do) this

because it is the right (wrong) thing to do” (Donaldson and Preston 1995, p. 72). The *managerial* aspect recommends attitudes, structures, and practices that, taken in aggregate, would constitute stakeholder management. By default, stakeholder management requires simultaneous attention to the legitimate interests of all “appropriate” stakeholders of the firm. Jones (1995) summarizes these four aspects as theories that address the questions of (a) what happens? (b) what happens if? and (c) what should happen?, respectively.

Donaldson and Preston (1995) do not agree that stakeholder theory should necessarily imply that all stakeholders, however they may be identified, should be *equally* involved in all processes and decisions taken by the firm. The managerial aspect would ask the question of “Who are the legitimate stakeholders?” For instance, potential job applicants, though unknown to the firm, do have a stake in being considered for a job; hence can be broadly classified as a particular type of stakeholders of the firm. Should the management treat them equally as other stakeholders then? Donaldson and Preston point out that it is essential to distinguish *influencers* from *stakeholders* – some actors in the corporation (e.g., large investors) may be both. Some recognizable stakeholders (e.g., prospective job applicants) have no influence, and some influencers (e.g., the media) have no stakes at all. Donaldson and Preston conclude that the stakeholder theory is fundamentally normative. It implies that other normative theories (e.g., the “management serving the shareholders” theory) are morally untenable. Instead, stakeholder theory is supported by other prescriptive theories (such as the theory of property rights).

Jensen (2002) also concurs that stakeholder theory, to the extent that firms should pay attention to all their constituencies that can affect the firms, is unassailable. He regards it as indifferent to value maximization. He states that stakeholder theory is fundamentally flawed because it violates the proposition that any organization must have a single-valued objective as a precursor to purposeful or rational behaviour. A firm that adopts stakeholder theory, according to Jensen, will be “handicapped in the competition for survival because stakeholder theory politicises the corporation and leaves its managers empowered to exercise their own preferences in spending the firm’s resources” (Jensen, 2002, p. 237). He proposes an *enlightened value maximization approach* to weld with *the enlightened stakeholder theory* so that, over the long-term, a firm can choose maximization of total market value as the criterion to evaluate manager’s performance. In so doing, a firm may justify ranking stockholders above all other constituencies such as customers, employees, financial backers, suppliers, regulators, and communities.

Jensen (2002) hypothesises that the self-interests of managers will lead them to prefer stakeholder theory because it increases their power. It also means they cannot be held responsible for their actions. Similarly, the self-interest of special interest groups who wish to acquire legitimacy to enhance their influence over the use of corporate resources will also advocate the use of stakeholder theory. If both of them are successful, it leads to the normative conclusion that society will be worse off.

The review of the theoretical frameworks above shows that the need for corporate governance within the firm is always present, regardless what theoretical framework a firm chooses to operate with. In agency theory and transaction cost economics theory, corporate governance plays an important role in regulating the contracting parties, settling disputes, and ensuring that alignment of interests of both the principal and the agent is achieved. Within the context of stakeholder theory of the firm, corporate governance also plays a decisive role in enriching the firm's capability to sustain a long-term survival goal. This is achieved by addressing the concerns of various stakeholders, including the government regulatory bodies and minority shareholders. Each of the theoretical frameworks stresses on a different aspect for the firm's insiders to interact with the firm's outsiders, but the need for mechanisms to ensure effective governance of a firm remains unchanged.

This study adopts the most common theoretical framework of the firm – the agency theory framework – to examine the relationship between the insiders' voluntary disclosure of corporate governance and the outsiders' valuation of the firm. Compared with the transaction cost economics theory and stakeholder theory, the agency theory framework is able to provide a clearly defined boundary for researchers to analyse the decisions made by just two parties: the insiders (i.e., the agents) and the responses made by the outsiders (i.e., the investors). It also facilitates the study of interactions between these two parties. The objective is to identify as to whether a relationship exists between the causes and effects of actions undertaken by each party. Furthermore, unlike stakeholder theory, agency theory focuses on what is being carried out (i.e., a positive approach) rather than what should be carried out (i.e., a normative approach) by the managers of a firm. It does not impart value judgement into the actions of the players in the interactions of the involved parties.

Consequently, this study adopts the perspective from the shareholders' rather than the stakeholders' in the analysis of relationships of voluntary CG disclosure, firm valuation, and dividend payouts. Relative to the stakeholders' perspective, the shareholder's perspective is less complex and more manageable: it assumes shareholders are mainly concerned with their investment's returns and/or its appreciation in value. Other social goals, such as equitable redistribution of wealth among various strata of the society, social justice in terms of fair competition, or sub-maximisation of resources utilization due to inequality in employment rights, etc. are not explored in this analysis, even though they are important to a firm's long-term survival, as suggested by the stakeholder theorists. This study focuses on the interrelationship between a firm's valuation, as well as its dividend payouts, and the firm's voluntary disclosure of its corporate governance mechanisms. The following section will discuss the various types of governance mechanisms applicable to the firm.

## 2.4. Corporate governance mechanisms

### 2.4.1 Ways of classifying corporate governance mechanisms

When corporate governance is defined as a set of control mechanisms to govern the relationship between the corporation and its shareholders, there can be different ways to classify the mechanisms. Luo ((2007) classifies corporate governance mechanisms into three categories: (a) market-based, (b) culture-based, and (c) discipline-based.

The *market-based* governance mechanisms comprise ownership concentration, board composition, market discipline, board chairmanship, board size, management remuneration, interlocking directorate, and inbreeding. The *culture-based* mechanisms include governance culture and corporate integrity. The *discipline-based* mechanisms encompass the executive penalty, internal auditing, conduct code, and an ethics programme. While Luo's classification is useful in interpreting the corporate governance systems in an international business setting, in particular the relationship between the parent company and its subsidiaries all across the globe, the classification itself incorporates broad components which can be grouped under two categories: (1) internal mechanisms and (2) external mechanisms to the firms (Bushman and Smith, 2001; Cremers and Nair, 2005; Gillan, 2006).



Broadly speaking, *internal* mechanisms govern the relationship between the board of directors and management. The board of directors is regarded as representatives of the principal, and management as the agent. *External* mechanisms, arising from the firm's need for raising capital, cover the laws, rules, and factors that influence the operations of a firm from the perspective of capital providers who are the shareholders and the debt-holders vis-à-vis the capital managers. The capital providers are collectively regarded as the outsiders while the directors and managers (i.e., the capital managers) are collectively addressed as the insiders (as per Shleifer and Vishny, 1997; Gillan and Starks, 2003).

It must be pointed out that the distinction between internal and external mechanisms does not necessarily imply that each one can displace one another; nor does it imply that a firm is at liberty to adopt some less restrictive internal mechanisms in order to circumvent more severe disciplinary actions or penalties imposed by the external mechanisms. In fact, Cremers and Nair (2005) find empirical evidence that suggests internal and external mechanisms interact and work together to affect the governance in a firm. They are complements, rather than substitutes, in being associated with the firm's long-term abnormal returns as well as its accounting measures of profitability. The following sub-section 2.4.2 summarizes the various practices of internal mechanisms, while sub-section 2.4.3 is going to discuss the various types of external mechanisms.

## **2.4.2 Internal mechanisms**

The following practices are some internal mechanisms of corporate governance commonly agreed upon by extant researchers (Gillan and Starks 2000, 2003; Gompers, Ishii, and Metrick, 2003; Cremers and Nair, 2005; Gillan, 2006). They form the basis of a firm's internal corporate governance structure. The extent to which a firm discloses these mechanisms becomes the focus of research in this study. As will be discussed in Chapter 8, a majority of them are considered in this study as components of the disclosure score (CGDscore), to be used subsequently in the analytical models in this thesis.

### *i) Board of Directors*

The Board of Directors is seen as “the apex of the internal control system”. It is vested with the power to “hire, fire, and compensate the CEO, and to provide high-level counsel” (Jensen, 1993, p.862). Empirical research studies have documented that *board size*, *board composition*, and *CEO/Chairman duality* have decisive effects on the monitoring of a firm's manager activities as reflected in the firm's performance. While *board size* relates to

the group dynamics and efficiency in reaching consensus among members of the board, *board composition* focuses on the board independence from the influence of the CEO/Chairman, and *CEO/Chairman duality* is concerned with the issue of concentration of power in one person's hands (Booth, Cornett and Tehranian, 2002):

*a) Board size*

Jensen (1993) cautioned that boards with 8 people or more are less likely to function effectively and are easier for the CEO to control. His postulation is supported by empirical studies showing that:

- i. For the large firms, the smaller the board size is, the higher is the firm valuation as expressed by Tobin's  $q$ <sup>1</sup> (Yermack, 1996). Firms with small boards are more effective in monitoring and efficient in decision-making. They have higher market values, stronger financial ratios, and greater CEO incentive scheme with higher threat of dismissal of the CEO than firms with larger boards.
- ii. For the small firms, the larger the board size is, the lower is the profitability. Eisenberg, Sundgren and Wells (1998) find a board-size effect in 900 small Finnish firms and document a negative correlation between firms' board size and firms' profitability, as measured by industry-adjusted return on assets. The factors that influence the board size of small firms differ from those of large firms. Small firms are usually tightly held; they tend to have less agency problems than large firms. Although Eisenberg, Sundgren and Wells (1998) do not find an ideal board size, they posit that the ideal board size varies with firm size.

In conclusion, a larger board tends to have increased problems of communication and coordination, and decreased ability to control management. A board with more than seven or eight members is less likely to function effectively and is susceptible to CEO's inverse control (Lipton and Lorsch, 1992). Therefore, board size does matter in the monitoring and control of management (Eisenberg, Sundgren and Wells, 1998). Board size is quantitatively measurable. In this study, board size is classified as a firm's corporate governance practice variable. It will be employed as one of the explanatory variables in the structural models to explain a firm's valuation as well as its level of voluntary corporate governance disclosure (to be discussed in Chapter 7).

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<sup>1</sup> Simply stated, Tobin's  $q$  is a measure of a firm's performance. It provides an estimate of a firm's market value that consists of a firm's tangible and intangible assets (e.g., goodwill, management quality, monopoly power, and growth opportunities) scaled by a firm's replacement cost (Perfect and Wiles, 1994). Chapter 8 has more discussion on the definition of Tobin's  $q$  and its usage as a proxy for a firm's market valuation of the firm's assets.

*b) Board composition/ direct board monitoring*

Fama and Jensen (1983b) argue that boards dominated by a greater number of outside directors (i.e., non-executive directors) vs. inside directors (i.e., executive directors) would be in a better position to monitor and control managers than would boards dominated by insiders because outsiders have a reputation to protect as effective, independent decision-makers. Weisbach (1988) provides empirical support that outsider-dominated boards behave differently from insider-dominated boards in their decisions to remove top management. Firms with outsider-dominated boards are significantly more likely to fire the CEO on the basis of poor performance such as low earnings or stock returns. Mayers, Shivdasani and Smith (1997) also find empirical evidence that companies employing more outside directors have lower costs, particularly salary expenditures, even in a highly regulated industry such as the insurance industry.

Jensen (1993) suggests that the only insider member sitting on the board should be the CEO. This is so because the possibility for animosity and retribution from the CEO is too great that it is almost impossible for anyone who reports directly to the CEO to engage openly, and critically, in the evaluation and monitoring of the CEO at the board meetings. However, the board members should seek opportunities regularly to meet with the senior executives below the CEO for two purposes: (i) to expand their knowledge of the company and CEO succession candidates; and (ii) to enhance communication with the top-level executives about the board thinking and board process. In this study, the proportion of the outside directors (i.e., independent non-executive directors – INEDs) of the total board is considered as another corporate governance practice variable. It will enter the structural models as one of the explanatory variables to test for the value relevance of voluntary CG disclosure. It will also be used as an explanatory variable to test for a firm's level of voluntary CG disclosure (to be discussed in Chapter 7).

*c) Chairman of the board and CEO duality*

Fama and Jensen (1983a) propose to control the agency problems by separating the ratification and monitoring of decisions (i.e., the *decision control* function) from initiation and implementation (i.e., the *decision management* function). The function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO (Jensen, 1993). When the same person takes up the dual roles, there will be conflicts of interest and the board cannot objectively perform its key functions

in evaluating the management's performance. Without an independent Chairman sitting on the board, it would be "extremely difficult for the board to respond early to failure in its top management team" (Jensen, 1993, p. 867). Therefore, for a board to be effective, the role of the chairman and CEO should be separate.

In contrast, Brickley, Coles, and Jarrell (1997) argue that separating the Chairman and CEO positions may incur costs in monitoring the Chairman (the "Who monitors the monitor?" argument). They document empirical findings that firms with Chairman/CEO duality perform no worse than those that have separate roles. Their empirical study shows that the costs of separation of the dual roles are larger than the benefits for most large firms.

The argument offered by Brickley *et al* is considerably weakened by the East Asian economic crisis (1997), the fall of Enron (2001), and the collapse of WorldCom (2002) during which investors incurred colossal financial losses and many market economies were devastated, due to the weak corporate governance caused by the failing boards of directors in losing control over top management's reckless activities. Assuming the split between the roles provides a legitimate, bona fide, check-and-balances on the over-empowering CEO, the cost of separation of Chairman/CEO duality can be expected to be compensated by the potential benefits to the investors at large.

In summary, past research shows that the board of directors may not perform its check-and-balance role to a desirable standard as often as it should. Lipton and Lorsch (1992) and Jensen (1993) have criticized large boards' performance due to the problems of poor communication and coordination in the decision-making process. Yermack (1996) finds empirical evidence to support an inverse relationship between board size and firm value. Bebchuk and Fried (2003) show that the board of directors is a weak monitoring instrument when the board is composed of members who "generally wish to be re-appointed to the board" (because a directorship is likely to provide prestige as well as valuable business and social connections) (Bebchuk and Fried, 2003, p. 73). It is often the case that the Chief Executive Officer (CEO) dominates the board by appointing and re-nominating directors to the board. Hence, directors (including *outside* directors) have an incentive to favour the CEO in order to "stay in management's good graces, so that they can be re-elected and continue to collect their fees" (Hart, 1995, p. 682). In this research, duality of Chairman and CEO of the sample firms is observed and recorded by a dummy variable SplitRole whereby '1' denotes the role of the Chairman is split from the CEO's

for the firm, and '0' denotes duality. SplitRole is used as one of the CG practices variables in the structural models (to be discussed in Chapter 7).

*ii) Ownership structure /ownership concentration*

Agency theory prescribes that ownership structure and ownership concentration have an impact on a firm's corporate governance. Jensen and Meckling (1976) hypothesize that as managers increase their stock ownership of the firm, their interests become more and more aligned with those of the outsiders, i.e., the minority shareholders. On the other hand, the shareholding in both equity ownership and voting rights by the outsiders provides a strong mechanism of corporate governance as it shapes managerial behaviour (Agrawal and Mandelker, 1987) and determines the capital structure of the firm (Harris and Raviv, 1991).

Concentration of ownership can range from a substantial minority ownership (e.g., 10% or 20%) by one or several investors, to an outright control with 50%+ ownership by the same investor(s). In a one-share-one-vote system, control rights can be concentrated in a few investors when the investors collectively own a large cash flow stake. Under such a scenario, it is easier for the investors to take concerted action (e.g., if some preferential voting rights are vested in some preferential share-holders) than when the control rights are split among many of them. Shleifer and Vishny (1997) argue that the concentration of ownership through large share holdings is a "nearly universal method of control that helps investors to get their money back" (Shleifer and Vishny, 1997, p.774).

Shleifer and Vishny (1997) point out that large minority shareholders need to make alliances with other investors to exercise control over a firm. Otherwise, the power of the managers to interfere in these alliance formations is greatly enhanced. Hence, the courts will have a greater burden to protect large minority shareholder rights. It follows that "large minority share holdings may be effective [in corporate governance] only in countries with relatively sophisticated legal systems, whereas countries where courts are really weak are more likely to have outright majority ownership" (Shleifer and Vishny, 1997, p.755).

It is therefore important to seek evidence, if any, for countries where the legal protection system is strong and yet there is a high concentration of family/insider ownership and a high possibility of expropriation of minority shareholders' wealth. In this scenario, there can be an extreme case such that the outsiders, having a minority voting right, are exposed

to the potential expropriation of their wealth by the majority shareholder. Under such circumstances, the minority shareholders can form an alliance and seek protection under the legal and regulatory regime to safeguard their interests against the majority shareholder. However, their efforts in exercising effective control over the firm may be severely curtailed because the majority shareholder can veto against any resolutions not to his/her liking by exercising the majority shareholder's rights. Suspicion of being unfairly treated by the insiders, therefore, may culminate and be reflected on the market valuation of the firm. On the other hand, if the firm installs proper corporate governance mechanisms and makes voluntary disclosure to the market, it may help to clear the doubts of the minority shareholders whose confidence in the security of their investments in the firm may increase. As a result, the market valuation of a firm may stay at a higher level. This study will examine whether ownership concentration and the voluntary disclosure of a firm's corporate governance practices have any effect on the valuation of listed firms in Hong Kong that have a high family/insider ownership.

### iii) Institutional block-holders

Cremers and Nair (2005) argue that the number of large block-holders, institutional stockowners (i.e., mutual funds, pension, funds, trust funds, etc.), and the proportion of shares they own (e.g., larger than 5%) tend to make these institutional investors active shareholders. These institutional investors acquire decisive influence not only in domestic financial markets but also across a country's borders. By owning a significant portion of the capital of many firms (usually large-sized ones), these institutional investors are active in influencing the strategic policies of the firms if not the firms' management practices. Jeffers (2005) identifies three factors why institutional investors develop their accumulated masses of financial assets:

- a. World deregulation of financial markets help eliminate obstacles to the financial capital circulation;
- b. Main industrialized countries budget deficits have led to more issuing of public bonds; and the governments' increased resort to the financial markets for finance restructuring and expansion;
- c. The financial assets in the mid 1990s have experienced steady appreciation in value over a long-term period. Coupled with lower rates of taxation by competing financial markets, many employees have increased their savings plans in the retirement pensions which in turn stimulate further investment in the financial assets.

In short, there has been a clear trend for the middle class households to shift their savings in the direction of the stock market since the late 1990s. Fund managers are now vested with more assets and responsibilities to generate decent returns on their investments to the pension holders, causing the rise of ‘shareholder activism’ and forming allies to coordinate shareholder actions in the late 1990s (Gillan and Starks, 2000; Monks and Minow, 2004). Gillan and Starks (2000) document empirical evidence that proposals sponsored by ‘gadflies’ (active *individual* investors) garner few votes while proposals sponsored by institutional shareholders receive significantly more votes by the shareholders. They conclude that institutional investors and coordinated block-holders appear to be applying pressure to managers. Such actions appear to have some small but measurable negative impact on the firm’s stock prices (Gillan and Starks, 2000, p. 303).

In this study, institutional block-holders’ ownership is not analysed for the sampled firms because of two reasons. First, the data on institutional block-holders’ ownership are not consistently disclosed in the annual reports. There is no obligation for a firm to disclose in its annual report if the block-holder’s shareholding does not exceed 10% (HKEx *Listing Rules*). Even if a firm knows there is an institutional block-holder as its shareholder, it can exercise discretion not to disclose the block-holder’s identity so long as the block-holder’s shareholding is below the 10% threshold. Second, a block-holder may choose not to let it be known its level of stock-holding to the firm’s management for various reasons (provided its equity holding is below 10%). Some institutional investors may invest in a firm for short-term (e.g., for window-dressing purposes) rather than on a long-term strategic basis. They may not like the idea that their shareholding in a specific investee firm to be disclosed to the public/competitors. Hence, a non-disclosing investee firm does not necessarily imply there is no institutional ownership. Conversely, a disclosing firm does not necessarily guarantee that the institutional investors have been long-term investors. Consequently, the information about the level of institutional ownership of firms is not complete in the sample firms’ annual reports. Hence, the presence of institutional investors, and the level of their ownership if they are present, is not employed as a variable in this empirical study.<sup>2</sup>

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<sup>2</sup> The lack of comprehensive data on long-term institutional ownership of Hong Kong firms is one limitation of this empirical study. Recent investor activism movement, however, suggests institutional investors can be a mediator between the general shareholders and management, hence should play a significant monitoring role in the corporate governance of a firm (Ferreira and Matos, 2008).

iv) Bank ownership of equity/ bank's influence

Banks play an important monitoring role in a firm's corporate governance mechanism in the capacity of a creditor and an investor. By making loans to a firm, banks put themselves in a strong position to monitor the firm's performance in their decision to renew the loans. It is therefore not unusual for a bank to influence a firm's major decisions. In some countries (e.g. Germany and Japan), banks may end up holding equity as well as debt of the firms they invest in. Like any other large shareholders, banks that have large stakes in the firm may want to see the returns on their loans materialized (Shleifer and Vishny, 1997).

In Germany where the stock market is relatively small, the link between cash-flow rights and control rights is less paramount and is somewhat uncoupled. Gorton and Schmid (2000) find that banks in Germany are empowered by legislation to vote on significant blocks of shares, sit on boards of directors, play dominant roles in lending decisions, and operate in a legal environment favourable to lenders. Banks can legally face conflicts of interest over some ranges of bank equity holdings, proxy-voting and other non-bank shareholdings. Gorton and Schmid observe that German banks are large, active, informed investors that can exercise substantial influence over the firm's operation and are able to effect management and strategic changes of the firm when circumstances warrant (*ibid*, 2000, p. 30). They find evidence that the bank's long term control rights derived from concentrated equity ownership significantly improve firm performance beyond what non-bank blockholders can achieve. In fact, in Germany the banks are so powerful that they can undermine shareholders' equity control rights. However, in Gorton and Schmid's empirical study, they do not find evidence that proxy voting is used at all by banks.

In Japan, Kaplan and Minton (1994) find evidence that banks as well as inter-corporate relationships play a very important monitoring and disciplinary role in corporate governance. CEOs' turnover rate substantially increases in the year when banks appoint outside directors to sit on the corporation's board of directors. Kang and Shivdasani (1995) also find evidence that firms in Japan with ties to a main bank are more likely to remove top executives for poor earnings performance than are firms without a main bank. Banks and the inter-corporate relationships are so strong that they can substitute other market-based control mechanisms such as hostile takeovers, proxy fights, and public contests for corporate control.



In Hong Kong (from where the sample for this study is drawn), banks normally will not be interested in holding large stakes in other business corporations over a prolonged period of time. Unlike Germany and Japan, banks in Hong Kong need approval from the regulatory body (i.e., the Hong Kong Monetary Authority – HKMA) to hold significant stakeholdings in other business entities that may in aggregate exceed 5% of the bank's capital base. **The Hong Kong Banking Ordinance** (Cap. 155) stipulates that:

“A bank shall be subject to a condition that it shall not acquire all or part of the share capital of a company to a value of 5% or more of the capital base of the institution (i.e., the bank itself) at the time of the acquisition unless the approval of the Monetary Authority (HKMA) has been given to the proposed acquisition of such share capital.”  
(Cap. 155, Sect. 87A).

Furthermore, the HKMA may revoke its approval anytime as it thinks fit. As such, banks in Hong Kong avoid holding a firm's equity for an unnecessarily long period of time. Therefore, the monitoring role of banks in a borrowing firm's corporate governance in Hong Kong is only confined to ensuring the loans are not abused and that the loan-repayment capability of the firm is well kept in place.

As the incidence of bank ownership of Hong Kong firms is few and far between, it is not considered as an explanatory variable in this empirical study. However, a firm's leverage (defined as total debt over total assets), which is a firm-specific characteristic, is included in the analytical models of this study as a control variable to explain the value relevance of the voluntary CG disclosure (as will be discussed in chapter 7).

#### v) Corporate by-laws and charters

Corporate by-laws and charters specify the rights and duties of various members of the firm. These rights may range from the compensation packages for senior management to the rights of the minority shareholders. For example, there may be specific requirements governing: the formation of a staggered (or classified) board for the directors; the cumulative voting rights for the shareholders; the special (or extraordinary general) meeting rights for the minority shareholders; the procedures to conduct secret ballot for proxy fights; the provisions for “poison pills” for stock dilution in case there is a takeover; and the “golden parachutes” for compensating key personnel after a change in control, etc. (Gompers, Ishii and Metrick, 2003; Cremers and Nair, 2005).

The presence of these corporate by-laws, the way they are written in the company charters, and how they are applied as and when occasions arise to demand their implementation, can

be expected to have an impact on investor confidence in the effectiveness of the firm's corporate governance system. Such a governance system, within an individual company and across an economy as a whole, "helps to provide a degree of confidence that is necessary for the proper functioning of a market economy" (OECD, *Principles of Corporate Governance*, 2004, p. 11).

Due to the unavailability of data on individual firm's corporate by-laws and charters (unless the researcher is a shareholder of each sample firm), the corporate by-laws are not employed as an explanatory variable in this study. Nevertheless, by-laws are a significant mechanism that an investor can rely upon as they are often the first line of defence for protection from a majority shareholder's un-equitable treatments or from the insiders' expropriation.

#### vi) Audit Committee

The International Organization of Securities Commissions (IOSCO) defines the audit committee as a governance body or bodies within an entity's corporate governance structure overseeing an external auditor's independence. The audit committee that is "in both appearance and fact independent of management of the entity being audited and acts in the interests of investors should oversee both the process of selection and appointment of the external auditor and the conduct of the audit" (IOSCO, 2002, p.6). Although the external auditor is formally accountable, and commonly reports, to the shareholders, in practice the auditor seldom has a direct relationship with them. Therefore, the audit committee should serve as a proxy for the shareholders.

To enhance the corporate governance standard of firms in Hong Kong, the HKEx has strongly recommended all listed firms in Hong Kong to set up audit committees. The HKEx also explicitly suggests the composition of the audit committee – the minimum number of members sitting on the committee as well as the qualifications of some of the committee members – based on the recommendations of the Hong Kong Society of Accountants (HKSA).<sup>3</sup> The presence of an audit committee, therefore, is one of the components of the corporate governance disclosure index (CGDscore) to be constructed for the purpose of this study.

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<sup>3</sup> More discussion on the background and development of corporate governance practices for Hong Kong firms will be presented in chapter 5.

vii) Managerial compensation and incentive plans

Agency theory postulates that agency problems can be ameliorated by manager incentives alignment. It implies that mechanisms such as compensation policy, bonus scheme, provision of perquisites and the like can be so designed as to provide the managers with value-increasing incentives. These mechanisms may include: salary revisions, outstanding stock options, stock ownership, and performance-related bonuses (or dismissal, if targets are not met).

Consistent with the previous discussion on ownership structure and ownership concentration in sub-section 2.4.2 of this chapter, Ang, Cole, and Lin (2000) find empirical evidence from small firms that agency costs do increase as the manager's equity ownership declines. They use two proxies for agency costs: the ratio of operating expenses to annual sales, and the ratio of annual sales to total assets. They compare the small firms managed by the owners with those managed by an outsider. Their findings support the implications of agency theory in that agency costs are significantly higher when an outsider rather than an insider manages the firm. Their research, however, does not consider the entrenchment problem of the insiders.

Jensen and Murphy (1990) do not find empirical evidence in support of a strong pay-for-performance incentive for the chief executive officers (CEOs) based on a *Forbes* survey of 2,213 CEOs from 1974 to 1986. Their empirical results show that bonuses were not highly sensitive to performances (as measured by changes in market value of the firm's equity, accounting earnings, or sales). The average salary plus bonus for the top 25% CEOs, in 1986 constant dollars, actually fell in the period 1974-86 when compared with the same in the period 1934-1938. Jensen and Murphy hypothesize that, in their sample cases, CEO compensation is often decided by the compensation committee comprising some outsiders who may not be perfect agents for the shareholders. They conclude that political and organizational forces (e.g., politics, regulations, media criticism, and public ignorance) operating both in the public sector and inside the firms are in play; and these forces limit large executive payoffs to exceptional performance.

In Hong Kong, the HKEx encourages the listed firms to establish a remuneration committee to determine the firm's policy and structure for all remuneration of directors and senior management. It requires a formal and transparent procedure for setting remuneration policy and specifies that a majority of the members of the remuneration

committee should be INEDs (Appendix 14, *Listing Rules*, HKEx, 2005, para. B.1). The remuneration committee is regarded as a component of a firm's corporate governance mechanism. In this study, the existence of a remuneration committee is captured by the CG disclosure score CGDscore by adding '1' to the score if it is disclosed in the firm's annual report, and '0' if it is not disclosed. More scores will be added if the composition of the remuneration committee is disclosed (as will be discussed in Chapter 7). The CGDscore, with other control variables, will then be used in the analytical models to test for its market relevance.

It should be pointed out that sometimes the independent non-executive directors (INEDs), or minority outside directors, may not be effective in monitoring a dominant CEO because the latter can be powerful and influential in their own appointment as outside directors. Core, Holthausen & Larcker (1999) find empirical evidence that the CEO compensation is an increasing function of the outside directors as a percentage of the board who are appointed by the CEO. Moreover, the CEO compensation is a decreasing function of the CEO's equity ownership. This finding is supported by Cyert, Kang & Kumar (2002) who find empirical evidence that the CEO compensation is strongly and negatively related to the largest external shareholder's equity ownership as well as to that of the board of directors. In other words, firms with weaker governance structures may pay their CEOs more. Due to data availability, this study controls for the presence of the remuneration committee amongst the sample firms, but does not control for the level of the CEO compensation of each firm *per se* in the analyses of the value relevance of voluntary CG disclosure.

To conclude, internal corporate governance mechanisms help clarify, mitigate, and adjudicate the risk-sharing relationship between the investors and managers. Firms can endogenously decide on the extent of these mechanisms and the use of governance provisions thereof. Danielson and Karpoff (1998) study 513 U.S. firms in the Standard & Poor 500 from 1984 to 1989. On one hand, they find that the uses of governance mechanisms are mutually independent for some provisions (e.g., poison pills). On the other hand, they find some provisions are used in conjunction with others (e.g., most anti-takeover charter amendments such as staggered board, super-majority provisions, and shareholder meeting requirements). In other words, the uses of some provisions of mechanisms are correlated and are not independent, but they have a collective impact on a firm's overall corporate governance. The following sub-section 2.4.3 will discuss the

external mechanisms, which may also have significant impact on a firm's corporate governance and the level of protection offered at large to the investors.

### **2.4.3 External mechanisms**

This sub-section summarizes the various types of external corporate governance mechanisms as discussed by previous CG studies. External corporate governance mechanisms generally refer to those macro-economic and market-level factors such as market competition, government bodies, legal institutions, as well as other mechanisms that are not embedded inside the firm. Conventional theorists of the firm often consider these external mechanisms as powerful deterrents to gauge against corporate managers' endeavours to seek self-interests (Manne, 1965; Grossman and Hart, 1980; Jensen and Ruback, 1983; Ikenberry and Lakonishok 1993). Legal theorists of the firm, however, put emphasises on the legal framework and the enforcement of the law in providing investor protection to the financiers and the minority shareholders (Shleifer and Vishny, 1997; LLSV, 1997, 2000a, 2002; Shleifer and Wolfenzon, 2002). These external CG mechanisms are also regarded as effective in resolving agency problems on a market-wide level. However, as the research objectives of this study are mainly concerned with the determinants of firm-level CG and their value relevance within the same market (i.e., Hong Kong), the external CG mechanisms are assumed to be affecting indiscriminately all sample firms within the market all the same. As such, this study concentrates on the voluntary disclosure of a firm's internal CG mechanisms but does not explicitly control for the external mechanisms, which comprise the following:

#### *i) Market for corporate control*

The market for corporate control refers to the competitive forces and actions of replacing incompetent CEOs and/or other board members by means of takeovers (Manne, 1965; Jensen and Ruback, 1983). It gives shareholders both power and protection commensurate with their interest in corporate affairs. It may offer the following advantages: (i) a lessening of wasteful bankruptcy proceedings; (ii) more efficient management of corporations; (iii) the protection of non-controlling corporate investors; (iv) increased mobility of capital; and (v) a more efficient allocation of resources. In addition to the use of contracts in monitoring the managers in agency theory, some researchers point out that the market for corporate control (i.e., the takeover mechanism within the stock market) can

be a powerful means of disciplining a firm's management. Manne (1965) in his seminal work states that:

“(T)he control of corporations may constitute a valuable asset; that this asset exists independent of any interest in either economies of scale or monopoly profits; that an active market for corporate control exists; and that a great many mergers are probably the result of the successful workings of this special market.”

(Manne, 1965, p. 112)

Manne identifies three basic techniques in the takeover mechanism of corporate control: (i) the proxy fight; (ii) the direct purchase of shares; and (iii) the merger. He maintains that apart from the stock market, there is no objective standard of managerial efficiency. Only the take-over scheme provides some assurance of competitive efficiency among corporate managers. Of these three devices for corporate takeovers, he concludes that mergers would be the most efficient.

Jensen and Ruback (1983) view the market for corporate control as a market in which alternative managerial teams compete for the *rights* to manage corporate resources. The takeover market complements the managerial labour markets, both internal and external, and is therefore vital in the relationship between management teams and stockholders. Arbitrageurs and takeover specialists act as intermediaries in this market, facilitating transactions and valuation of mergers and acquisitions, tender offers, and proxy contests among competing management teams. The competition for the rights to manage resources thus helps reduce the divergence of maximization of shareholder wealth from the manager's pursuit of self-interests.

As pointed out in the beginning of this sub-section and like other market-wide factors that affect all firms operating within the same economy, this market for corporate control – though a powerful external CG mechanism – will not be included as a variable in this study. It is discussed in this section in order to illustrate that it may also impact on individual firm's desirable level of voluntary CG disclosure, albeit on a market-wide basis.

#### ii) Proxy fight

Proxy fight/contest is a device to influence the firm's management whereby individually tiny votes are collected from a vast number of shareholders (Mikami, 1999). In a proxy contest, shareholders are asked to give their proxies to either the incumbent or dissident management team to cast their votes on their behalf. Through their voting right,

shareholders may exercise the control authority embedded in their equity claims (Ikenberry and Lakonishok 1993).

Proxy fight is generally regarded as an expensive means for a dissident outsider to discipline incumbent management. Manne (1965) states that proxy fights are ‘the most expensive, the most uncertain, and the least used of the various techniques’ in the takeover devices (Manne, 1965, p. 114). Outside dissidents often find it costly and burdensome to launch a proxy fight unless there is a genuinely strong dissatisfaction among shareholders about the incumbent management’s performance. Alchian and Demsetz (1972, p. 97) state that proxy contests enhance the probability of decisive action when the current stockholders or any outsiders believe that ‘management is not doing a good job with the corporation’.

Dissatisfaction alone may not trigger off dissidents to stage a proxy fight. A free-rider problem is also present (Hart, 1995). Share price tends to rise when an outsider announces a proxy fight. By retaining their share to themselves or purchasing even more shares, other outsiders benefit from the free-riding. They may vote for the outsider who seeks control and wait for the sharing in the capital appreciation. As a result of the rise of share price, the shareholder wealth of the target firm usually increases at the announcement of proxy fights (Dodd and Warner, 1983; DeAngelo and DeAngelo, 1989).

Another reason that proxy fight is infrequently used to exert control over management is because the small shareholders often regard their vote is unlikely to make a difference and have little incentive to decide whom to vote for. Moreover, a small investor may continue to vote for the current management because “the devil you know is better than the devil you don’t” (Hart, 1995, p. 683).

Of the two devices used to influence management, Pound (1988) reports that in the period 1981-1984, there were over 250 tender offers<sup>4</sup> for publicly held U.S. firms, but only about 100 proxy contests of which less than 60 were for control. His cross-sectional tests provide support that proxy contests have systematic incentive problems that make

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<sup>4</sup> ‘Tender offers’ take place in a takeover battle over the control of a firm. The shareholders are invited to sell their stocks (referred to as a tender offer) to either the incumbent or dissident management team at an announced price. The management team that collects a sum of votes which exceeds a pre-determined level (usually 50% of the total votes) gains control rights over the firm. The major difference between the two devices – proxy contests and tender offers – is that tender offers are made through a financial market while proxy contests do not make use of it (Mikami, 1999, p.354)

dissidents harder to gain victory. He documents 3 types of inefficiency of proxy contests: (i) inefficiency in soliciting votes by the outsiders relative to the managers (insiders); (ii) large block-holders are more likely to support management than dissidents in proxy fights; and (iii) there is an adverse selection problem in proxy initiatives – dissidents with credible cases must spend resources to distinguish themselves from ‘crank’ insurgents. His views are echoed by Ikenberry and Lakonishok (1993), who carry out an empirical study on proxy fights in 97 U.S. firms over a period from 1968-1988. They find that contest target firms exhibit significantly negative abnormal returns and deteriorating operating performance prior to the start of a proxy fight.

The empirical findings discussed above have illustrated the difficulty faced by the dissidents to constrain a firm’s management by means of proxy fights. Proxy fights rarely happen when a predominantly shareholder owns more than 50% of the voting rights (but not necessarily 50% cash-flow rights). Similarly, under the circumstances when members of the same family own more than 50% voting rights, any dissident outsider would find it very difficult to launch a proxy fight to gain control of the management (unless there is a rift among the family members). In the case of Hong Kong firms where family ownership prevails, proxy fights will not be an effective external governance mechanism for the dissident minority investors because the majority shareholder, who is usually an individual or comprises members of the same family, can block the proxy contest by means of his/her majority votes derived from the shareholding.

### iii) Product market competition

The neo-classical economists hold that the conventional view of ‘profit maximization’ does not make any sense wherever there is incomplete information and uncertainty. It is because, under the condition of uncertainty, each action that may be chosen is identified with a *distribution* of potential outcomes; and that the *intention* to maximize is not a meaningful criterion for that action (Tintner, 1941; Alchian, 1950). Rather, they uphold the approach of impersonal, market competition, forces where success is based on results, not motivation.

This competitive-oriented approach embodies the principles of biological evolution and natural selection by interpreting the economic system as “an adoptive mechanism which chooses among exploratory actions generated by the adaptive pursuit of success or profits” (Alchian, 1950, p. 211). Market competition, pressure for profitability, and survival



conditions (e.g., individual adapting via imitation and trial and error) will push all participants to an optimal situation as a result of adaptation or adoption of actions in response to changes in the market environment. Moreover, the survival techniques such as cut-loss, outsourcing, and downsizing will guide all firms' actions in reaching the optimum size, one that "meets any and all problems the entrepreneur actually faces" (Stigler, 1958, p. 56).

Hart (1983) formalises a theoretical model that shows competition in the product market reduces managerial slack under the polar cases of perfect competition and monopoly in the product market. Nevertheless, his model does not explain how managers are disciplined in oligopolistic or monopolistic competitive environments. Moreover, product market competition is not the only source of discipline for managers; competition in the capital market has also an important role to play in limiting managerial slack via the take-over bid mechanism (Grossman and Hart, 1980).

Scharfstein (1988), however, contrasts with Hart's view. Market competition can exacerbate incentive problems depending on whether the firm owner is able to observe productivity (the entrepreneurial firm) or not (the managerial firm). In the latter case, the manager has self interests to under-report his productivity so as to satisfy a lower profit target set by the owner. Therefore, an incentive scheme must be topped up to induce the manager to reveal his private information about his productivity. When the manager is highly responsive to monetary incentives, a proliferation of managerial firms (i.e., more competition) may actually lead to more managerial slack.

Hermalin (1992) proposes an analytical model that identifies four effects of competition on manager's behaviour: (i) income effect due to reduced profits in a keener competition environment, (ii) risk-adjustment effect if profit risks vary with intensity of competition, (iii) change in the relative value of actions effect, and (iv) a change in the information structure effect due to more rival firms. There is no definitive theoretical relationship between the competition level and manager's behaviour. However, if agency goods (e.g., shirking, empire-building, perquisites) are to be construed as normal goods, then the income effect will push the manager to choose harder actions (i.e., will work harder and consume fewer agency goods) as competition increases.

While the relationship between product market competition and managerial incentives remain ambiguous, there are empirical studies confirming that more competition can lead to productivity growth. Nickell, Nicolitsas and Dryden (1997) investigate 580 UK manufacturing firms from 1982 to 1994. They identify 3 external factors in generating improved productivity: (i) product market competition, (ii) financial market pressure, and (iii) shareholder control. Nevertheless, they are unable to disentangle the reverse causality and the stability over time problems in their sample. For instance, keener product market competition can lead to improved productivity of individual firms, but it may as well be the result of higher output by all firms in the market. Januszewski, Koke and Winter (2002) study a panel of 500 German manufacturing firms from 1986 to 1994 and find evidence that product market competition has a positive impact on productivity growth. Their study also reveals that the disciplining effect of product market competition is enhanced by tighter control structures. Karuna (2007) examines data from 1,579 firms over the period 1992-2003 and finds evidence that when industry competition (as measured in terms of product substitutability and market size) is stronger, firms will provide their managers with stronger incentives. There is also empirical evidence that managerial incentive schemes are affected by industry characteristics.

Generally speaking, product market competition, like evolution, takes time to impact on disciplining a firm's management and the impact is unclear. Incompetent managers may also deploy various tactics (e.g. income smoothing and earnings management, hostile acquisitions, strategic divestments) to cover up their own failings, buy time to protect their entrenched positions within the firm, or shirk responsibilities to a third party. Product market competition may not function at all as an external corporate governance mechanism if the industry is oligopoly or monopolistic competition. In conclusion, product market competition does not provide either a timely or a cost-effective mechanism in monitoring agents. It will be even less so if the agents are themselves predominant shareholders of the firm. Like other external mechanisms, product market competition is assumed to be present for all sample firms in this single-country study and is therefore not considered as an explanatory variable in this study.

#### *iv) External managerial labour market*

Closely related to product market competition is the external managerial labour market, which is often accepted as one of the monitoring means of managers. Managers have a need to safeguard their reputation. They rent a substantial lump of human capital to the

firm. The rental rates for their human capital are signalled by the managerial labour market and are dependent upon the success or failure of the firm (Fama, 1980). Furthermore, job loss due to poor manager's performance lead to significant costs including reputation costs and the loss of future job opportunities (Chakraborty, Sheikh and Subramanian, 2007). Therefore, the current success or failure of a firm impacts the manager's outside opportunity wage, thus making the manager a stakeholder in the prospects of the firm.

On the other hand, firms have every reason to offer a reward system that compensates competent managers adequately. Provided the managerial labour market is competitive, the firm stands to lose managers when the firm's reward system is not responsive to performance; and more often than not the best are the first ones to leave (Fama, 1980). Subject to the wage revision process, a firm faces the pressure to sort and compensate managers according to performance.

However, empirical findings by Jensen and Murphy (1990) show that until the end of the 1980s, the U.S. top managers' compensation had on average a very low pay-to-performance sensitivity. The relation between the pay of top-level executives and firm performance is small. Their empirical findings receive support from Rosen (1992) whose survey on the CEO compensation indicates an elasticity of pay-to-performance ranges between 0.10-0.15. This is contrary to early agency theory's models of optimal contracting. Moreover, their findings suggest that dismissals are not an important source of managerial incentives because the increases in dismissal probability due to poor performance and the penalties associated with dismissal are both small. Their findings are contrasted by another study by Hall and Liebman (1998) whose 15-year panel data from 1980 to 1994 indicate that the pay-to-performance sensitivity of U.S. top executives' compensation has increased substantially due to the widespread use of stock-related incentives such as stock option plans.

External managerial labour market is also closely linked to the CEO turnover. Denis, Denis & Sarin (1997) study 1,394 firms from 1985-1988 and find that the probability of top executive turnover is negatively related to the equity ownership of insiders (i.e. top officers and directors). More importantly, when the insiders own between 5% and 25% of the firm's equity, the probability of the top executive turnover is significantly less than when officers and directors own less than 5%. In other words, the effectiveness of the external

managerial labour market as an external mechanism can be mitigated by the ownership structure, which will be further discussed in Chapter 3.

Although the external managerial labour market may serve as an influential component in a firm's corporate governance structure, the lack of a reliable measurement prohibits its usage as an explanatory variable in this study. This study focuses on the internal CG mechanisms and on their disclosure rather than on the external CG mechanisms. As such, the external managerial labour market is not considered in this study. A literature review on the external managerial labour market, like other external CG mechanisms, serves the purpose of identifying the alternative factors that may also have an impact on a firm's corporate governance structure and its CG practices.

*v) Anti-director rights*

LLSV (1998) define anti-director rights as those shareholders' rights that "measure how strongly the legal system favours minority shareholders against managers or dominant shareholders in the corporate decision-making process, including the voting process" (LLSV, 1998, p. 6). As illustrated by Boonlert-U-Thai, Meek & Nabar (2006), these shareholder rights can be protected through the following six provisions, if present in the legislature, by the law:

- 1) The country allows shareholders to mail proxy vote to the firm;
- 2) Shareholders are not required to deposit their shares prior to the general shareholders' meeting;
- 3) Cumulative voting<sup>5</sup> or proportional representation of minorities in the board of directors is allowed;
- 4) An oppressed-minorities mechanism such as the right to force the company to repurchase shares of the minority shareholders, or the right to challenge the directors' decisions in court, is in place;
- 5) The minimum percentage of share capital that entitles a shareholder to call for an extraordinary shareholders' meeting is stipulated;
- 6) Shareholders have pre-emptive rights to buy new stock (so as to protect shareholders from dilution) that can be waived only by shareholders' vote.

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<sup>5</sup> Cumulative voting permits minority interests to elect a minority of the directors. Under a cumulative voting system, proxy-holders cast their votes equal to the number of shares for which proxies are held multiplied by the number of directors. All votes may be cast for a single director position, or they may be distributed across positions in any way. The nominees from both incumbents and dissidents are then ranked in descending order, according to the number of votes received. The required number of directors is then elected from this ranking (Dodd and Warner, 1983, p. 403)

These anti-director rights can be construed as formal legal protection of shareholders wherever the principle of one-share-one-vote is violated. However, if these anti-director rights are already stipulated in the company's charter, the minority shareholders may not need to resort to external legal rules and regulations to redress their grievances against the insiders. Under such circumstances, these anti-director rights can be described as "internal mechanism".

*vi) Legal rules and regulations of the stock market*

La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV, 1997) attribute the size and effectiveness differences of capital markets around the world to the differences in investor protection against expropriation by insiders. Such investor protection is reflected by two elements: legal rules and the quality of enforcement. They argue that better legal protections enable the financiers to offer entrepreneurs money at better terms, hence more external financing will be used which in turn will lead to both higher valued and broader capital markets. Based on an analysis of 49 countries, LLSV find strong empirical evidence that the legal environment has large effects on the size and breadth of capital markets. In particular, LLSV also find strong evidence that stronger anti-director rights (and also one-share-one-vote rules) are associated with larger and broader equity markets.

Stronger legal protection leads investors to be more willing to accept lower expected rates of return. In turn, companies are more likely to use external finance when rates are lower. The overall impact is that there will be higher economic growth in those countries with stronger investor protection. Rajan and Zangales (1998) find evidence that financial development facilitates economic growth. They document that industrial sectors, which need more external finance, develop disproportionately faster in countries that have more developed financial markets. Wurgler (2000) examines 65 countries, using the size of stock market and debt market relative to a country's GDP as a proxy for financial development. He finds firms in countries with developed financial sectors increase investment more in growing industries and decrease it more in declining industries. This is considered as evidence in support of economic efficiency in allocation of capital within those countries where there are developed financial sectors. Johnson, Boone, Breach, and Friedman (2000) examine 25 countries during the Asian crisis of 1997-1998. They find that a country's degree of investor protection also affects the way its economy's capital market responds to adversity. They find evidence that the magnitude of the stock market decline and the

degree of depreciation of the exchange rate are negatively related to the degree of investor protection.

In sum, a strong economic growth requires developed financial markets. Strong investor protection is a necessary condition for strong financial markets to develop (Denis and McConnell, 2003). As Hong Kong strives for maintaining its economic growth and its financial market competitiveness in Asia, it needs to provide a strong investor protection, strengthen the corporate governance, and maintain a level playing ground for capital providers and capital managers. This study employs Hong Kong firms as samples so as to distinguish the value relevance of voluntary CG disclosure in a high level of legal protection regime. It differs from other studies that use firms from low levels of legal protection regimes in Asian countries (which businesses are also family dominated). The findings of this study will help further the understanding of how concentrated ownership affects voluntary CG disclosure, even though the investors are being protected by a strong legal regime.

*vii) Quality of enforcement of investor-protection rules*

Even though the investor protection legislations are in place, they need to be effectively enforced so that investors can have confidence that their rights are protected. Enforcement of laws is as crucial as their contents (LLSV 2000a, p.7). This is in sharp contrast to the contractual school of the theory of the firm as proposed by Jensen and Meckling (1976). According to the contractual school of firm theory, most regulations of financial markets are unnecessary because financial contracts take place between well-informed issuers and investors who are sophisticated enough to impute the necessarily default costs into the contract. The entrepreneurs bear these costs when they issue securities. They have an incentive to bind themselves with investors to limit expropriation. As long as the financial contracts are enforced, financial markets do not require regulations (Stigler, 1964; Easterbrook and Fischel, 1991).

LLSV (2000a) posit that good legal rules are the ones that a country can enforce. In the case of securities law reform, the strategy is “not to create an ideal set of rules, but rather to enact the rules that can be enforced within the existing structure” (LLSV, 2000a, p.22). Gillan (2006) regards litigation as an important element of the governance environment. Farber (2005) finds that firms charged with fraud by the SEC tend to have poor governance relative to a control group of firms. Haslem (2005) studies a broad range of lawsuits

including anti-trust, breach of contract, labour-related, patent infringement, and shareholder class actions. He reports that legal cases appear to dominate settling litigation from a shareholder wealth perspective. He also finds that weak governance firms tend to settle legal suits quickly, and that the market reaction to settlements is more negative in firms where agency costs are seen to be greater.

All these studies point out that both the rules and the quality of their enforcement are equally vital to investor protection. La Porta, Lopez-de-Silanes, and Shleifer (1999) establish that strong investor protection makes the equity market more attractive. It also makes ownership structure less concentrated. As pointed out by Li, Moshirian, Pham, and Zein (2006), large shareholdings by institutions are more prevalent in countries with stronger shareholder rights, greater access to voting rights, more effective legal enforcement, and extensive financial disclosure.

Among the seven mechanisms mentioned above, the market for corporate control is potentially the most powerful one to bring about improvements in corporate governance and to ensure that companies are well managed. Fama claims that “the market for outside takeovers providing discipline of last resort” (Fama, 1980, p.295). However, managers and insiders may devise protective provisions to shield themselves from the threat of being expunged in the case of a takeover when they negotiate their initial contracts with the owner (e.g., anti-takeover amendments, poison pills, dual-class voting structure, state anti-takeover laws, executive stock and option plans, and golden parachute contracts, among other means as per Agrawal and Knoeber, 1996, p. 378). Such provisions are installed and may be implemented to an extent that it becomes difficult to remove incapable managers, i.e., an “entrenchment” problem may arise. This is especially the case when the insiders predominantly own the firm (e.g., concentrated family ownership) and when outsiders are a minority on the board of directors.

Starting from LLSV’s influential papers (LLSV, 1997; 1998), many empirical researchers have found evidence in support of the significant relation between a country’s investor-protection against expropriation by corporate insiders and the expansion of capital markets and the economic development of a country (LLSV, 2000a). Bushman and Smith (2001) argue that financial accounting information can play an important role in corporate governance. Other than the traditional role in the setting of managerial compensation plans, financial accounting information is extensively used in the determination of: (i) economic

growth of the capital market, (ii) efficiency of the market economies, and (iii) economic performance of the firms. In particular, they propose that studies should be carried out on the economic effects of disclosures of specific types of financial accounting information, the frequency of interim reporting, and the accounting principles used to measure the disclosed items. Such studies shall provide new insights into what constitutes high- versus low-quality financial accounting systems from the standpoint of enhancing economic performance.

However, Cremers and Nair (2005) find that the internal and external mechanisms are strong complements in firms with low leverage. Their empirical findings support the theories that higher debt reduces the probability of a takeover as proposed by Novaes and Zingales (1995), Zweibel (1996), Stulz (1988), and Harris and Raviv (1988).

All in all, individual mechanisms are empirically found correlated to the firm's performance in terms of market valuation or accounting profitability. However, the exact mix of internal and external governance mechanisms that leads to the firm's improved performance is unclear although the *joint* impact of internal and external forces seems pronounced (Jensen and Warner, 1988). This study does not intend to examine the optimal mix of internal and external governance mechanisms. Rather, it assumes that the external mechanisms apply to all firms – large or small – under the same legal investor-protection regime. It also assumes that the market for corporate control and the product market competition forces are applicable to all firms in Hong Kong, as it is a free and open economy with very few government interventions or restrictions. This study only considers the voluntary disclosure of a firm's corporate governance practices as the factor that may vary, *ceteris paribus*, and examines its potential impact on a firm's market valuation and dividend payout.

## 2.5 Summary

Corporate governance is the system by which firms are directed and controlled. It deals with the ways how suppliers of finance can ensure that they will get their return on their investment (Shleifer and Vishny, 1997). A firm may consist of various stakeholders: the shareholders, the employees, customers, suppliers, creditors and the community; and in the widest sense, stakeholders may extend to “any identifiable group or individual on which



the organization is dependent for its continued survival” (Freeman and Reed, 1983). A considerable amount of prior literature has been made to reveal the problems arising from the course of various stakeholders in pursuit of their own interest, and the means to iron out those problems.

This chapter reviews prior literature on corporate governance. Various theories have been proposed by researches to understand and to tackle the problems of corporate governance: Agency Theory, Transaction Cost Theory, and Stakeholder Theory. The first two theories stipulate that corporate governance plays an important role in regulating the contracting parties, settling disputes and ensuring that alignment of interests of both the principal (owners) and the agent (managers who are not owners) is achieved. The Stakeholder Theory differs from the first two theories in proposing that corporate governance should pay attention to other stakeholders who are also affected by the firm’s actions even though they are remotely related to the firm. As discussed in section 2.3.4, this study adopts the shareholders’ perspective rather than the stakeholders’ one in the analysis of relationships of voluntary CG disclosure, firm valuation, and dividend payouts. The shareholders’ perspective is relatively simpler and more clearly discernible in regards to the parties involved in the analysis: shareholders would like their interests to be protected while at the same time they delegate the day-to-day decision-making power to the managers of a firm. The information asymmetry thus arisen from the separation of ownership and control gives rise to the need of setting up proper corporate governance mechanisms.

Broadly speaking, there are two categories of mechanisms – *internal* and *external* – that may help ensure the firm’s corporate governance is adequate to look after the interest of its stakeholders. Internal mechanisms including the board of directors, the board composition, the chairman/CEO duality, ownership structure/concentration, the presence of institutional block-holders, bank ownership of equity/ bank’s influence, corporate by-laws and charters, and the presence of an audit committee and remuneration committee, have been found to have an impact on the corporate governance of the firm. External mechanisms, such as corporate takeovers, proxy fights by minority shareholders, the degree of product market competition, the external managerial labour market and anti-direct rights, play as an invisible hand to help ensure that the firm exercises corporate governance to maintain a fair interest for all stakeholders. The legal rules and regulations of the stock market, by stipulating requirements that the listed firms have to follow, also help to ensure good corporate governance of the firms.

Corporate governance of firms in an economy/country has great impact on the social and economic development of that economy/country; and different theories proffer different solutions to the corporate governance problems that prevail across countries. As has been discussed in sub-sections 2.3.2 and 2.3.4, this thesis adopts the most widely accepted theory for corporate governance – agency theory – to examine the relationship between voluntary disclosure of corporate governance of a firm and a firm's market valuation. It focuses on some of the internal CG mechanisms rather than the external CG mechanisms available to the firm, and adopts the investor-protection perspective on the role of corporate governance. A second aim of this thesis is to examine how dividend payout can be used by outside investors to monitor the insiders in the context of a concentrated ownership by a predominant equity holder under a strong legal protection environment such as Hong Kong.

In the next chapter, Chapter 3, a study will be made of the impact of ownership structure and firm's leverage on a firm's corporate governance. It examines how corporate governance can be affected by a firm's ownership concentration, family ownership, and its leverage. The external mechanism, i.e., the legal protection of outside investors, will be the subject of Chapter 4 where voluntary disclosure and other firm characteristics that affect a firm's corporate governance will also be discussed. Discussion of the possible influence on a firm's valuation by these factors will also be provided.

# Chapter 3: Relationship between Corporate Governance, Ownership Structure, and Firm Leverage

## 3.1 Introduction

Agency theory posits that a firm's corporate governance (CG) has its roots in the firm's ownership structure (Jensen and Meckling, 1976). Denis and McConnell (2003) state that, when ownership and control of corporations are not fully coincident, there is potential for conflicts of interest between owners (i.e., the principal) and controllers (i.e., agents). These conflicts of interest form the basic ideas for research on CG (*ibid*, 2003, p.1). This chapter reviews the literature related to the theoretical arguments between corporate governance and two major firm-specific characteristics: the firm's ownership structure and the firm's leverage. Other firm characteristics that may be relevant to a firm's CG such as firm size, firm performance, and legal protection of minority shareholders will be discussed in Chapter 4. The motivations for voluntary disclosure of a firm's CG practices will also be discussed in the chapters that follow.

Prior theoretical research has suggested that a firm's corporate governance is related to ownership structure and the firm's leverage, among other variables. However, empirical studies have found that the strength of the relationship is neither universal across different types of ownership structure (Morck, Shleifer and Vishny, 1988; McConnell and Servaes, 1990), nor are the signs of relationships identical for firms operating in a strong legal protection environment and a weak environment (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2002). Since the present study aims at exploring the relationship between voluntary disclosure of CG and the firm's valuation, and since firm valuation, in part, also depends upon a firm's attributes such as ownership structure, firm size, and the firm's performance in terms of profitability, cross-listing, etc., an understanding of the existing literature on these relationships is necessary in building up the hypotheses to be empirically tested in this study.

The organization of this chapter is as follows: Section 3.2 explains why a firm's ownership structure matters in curbing its agency costs. It also reviews the extant literature on the varieties of ownership structure and discusses the relationship between managerial ownership and a firm's control, its corporate governance, its performance, and its disclosure. Section 3.3 elaborates on a special type of ownership structure – family

ownership and how it is related to firm value and corporate governance. Section 3.4 explores the significance of a firm's leverage (or capital structure) to agency costs, and discusses the relationship between leverage, ownership, and corporate governance. Section 3.5 summarizes the key concepts that serve as the bases for the empirical analysis to be conducted in this study.

### 3.2 Firm's ownership structure and agency problems

Both theories of the firm – the agency theory (Jensen and Meckling, 1976) and the stakeholder theory (Williamson, 1984; Freeman, 1984, 1994) – acknowledge that modern enterprises have dispersed ownership. According to Berle and Means (1932), modern enterprises tend to have diverse shareholders; each of them may own a tiny fraction of the firm's equity. These shareholders may not necessarily be the firms' managers who are responsible for the firm's daily operations. While the stakeholder theory posits that the managers are held accountable to a firm's numerous stakeholders who are not necessarily confined to its shareowners alone, the agency theory looks upon the managers as agents of the shareholders. These managers are responsible for the daily operations of the firm. They possess inside information about the firm unknown to the outsiders. If un-checked or inadequately monitored, managers may make use of this inside information to pursue their self-interests at the expense of the shareholders' who are placed at a disadvantageous position due to such information asymmetry. A potential conflict of interest therefore exists between the managers and the shareholders, as "agency costs arise when the interests of the managers are not aligned with those of the owners" (Ang, Cole, and Lin, 2000, p.83).

In their empirical study of 1,708 small firms extracted from the National Survey of Small Business Finances conducted by the U.S. Federal Reserve Board in 1992, Ang *et al* (2000) compare the excessive expenses (including managerial perks consumption) of firms that have partial managerial ownership and those of no-outside-equity firms. They provide direct confirmation of Jensen and Meckling's (1976) hypothesis that agency costs are indeed higher among firms that are not 100% owned by their managers and that these costs increase as the equity share of the owner-manager decreases. In their sample, Ang *et al* acknowledge that the agency costs take the form of preference for all job-related perks, shirking, and making self-interested and entrenched decisions that reduce shareholder wealth.

In the view of Jensen and Meckling (1976), agency problems arise because no contracts can be written and enforced without cost. Agency costs include the structuring costs, monitoring costs, and the bonding costs of a set of contracts between principal and agents, and also among agents with conflicting interests. Jensen and Meckling (1976) suggest several means to curb such agency problems, and managerial ownership of the firm is one of the means to align the interests of shareholders with those of the managers. The ownership structure of the firm, therefore, has impact on the corporate governance of the firm. As suggested by Lemmon and Lins (2003, p. 1445), ownership structure is also the primary determinant of the extent of agency problems between the outside investors and the controlling insiders. It has important implications for the valuation of the firm.

The following sub-sections review the extant literature on different forms of ownership structure within the U. S. and outside the U. S., based on the empirical studies which adopt similar classification of U.S. vs. non-U.S. firms as their samples. Ownership can be concentrated or diverse; and may vary from country to country. It is likely that agency problems arising from various types of ownership will differ. In turn, the plausible solutions to agency problems tend to differ. A discussion is provided herewith as to how a firm's ownership structure is related to its corporate governance, followed by a review of literature that examines the impact on firm performance by various forms of ownership structure.

### **3.2.1 Studies on ownership structure of firms in the U.S.**

Traditional studies on firm ownership began in the U.S. Berle and Means (1932) postulate that modern enterprises tend to have dispersed ownership, and there is a prevalence of widely held corporations in the U.S. with ownership widely diffused among small shareholders. There are several implications. First, the control and ownership of firms tend to be inevitably separated. As Means (1931) puts it: "Ownership of wealth without appreciable control, and control of wealth without appreciable ownership, appear to be the logical outcome of present corporate development" (Means, 1931, p. 68). Such separation of ownership and control of firms gives rise to agents, who are not the owners but act in the capacity of managers to make decisions on behalf of the principals (i.e., the shareholders). Second, Berle and Means (1932) observed that top corporate executives, "while in office, have almost complete discretion in management" (*ibid*, 1932, p.139). It

implies that, while ownership of capital is dispersed among small shareholders, control is concentrated in the hands of managers. Third, diffused ownership tends to render the owners of shares powerless to constrain professional managers, as suggested by Demsetz and Lehn (1985, p.1173). Agency problems would therefore tend to arise where managers engage in decision-making and behaviours that may not be consistent with maximizing shareholder wealth (Jensen and Meckling, 1976; Fama and Jensen, 1983a), as corporate resources may not be used entirely in the pursuit of shareholder profit.

However, some empirical studies in the 1980's find evidence that do not support Berle and Means's (1932) conception of dispersed firm ownership in the U.S. For example, Demsetz and Lehn (1985) find that the concentration of equity ownership of U.S. firms varies widely. Using a Herfindahl index<sup>1</sup> (with an unbounded range starting from the smallest value zero) as a proxy for ownership concentration of 511 large U.S. corporations including regulated utilities and financial institutions in 1980-1981, they find that ownership concentration varies from 0.69 to 4952.38, with a mean equal to 402.75 and a standard deviation of 722.99. With such a wide range of concentration levels, and such a relatively large standard deviation value compared to the mean, there is evidence that various degrees of ownership concentration are present among U.S. corporations.

Empirical evidence shows that, not only is dispersed ownership not at all the most prevalent form of ownership structure, there exists even a slight ownership concentration for U.S. firms. In a wider sample of 5,240 firms sourced from a public database Spectrum, Holderness and Sheehan (1988) identify 663 firms (i.e., 12.7%) that have majority shareholders (>50% equity) in the year 1984; and 114 of them have majority shareholders for at least two consecutive years between 1978 and 1984. These 114 firms constitute approximately 5% of the firms on the New York Stock and American Stock Exchanges. Moreover, these 114 firms are not confined to small or obscure firms, but consist of large, prominent, corporations such as Shell Oil U.S.A., A&P Stores, Commodore Computer, Continental Airlines, Playboy Enterprises, and Turner Broadcasting, with average assets exceeding USD 1 billion (median: \$128 million) and annual sales of USD 756 million (median: \$132 million).

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<sup>1</sup> Their Herfindahl index of ownership concentration is calculated by summing the squared percentage of shares controlled by each of the top 5 shareholders. The percentage of shares owned by the top 5 shareholders has undergone a logistic transformation, using the formula:  $\log [\text{percentage concentration} / (100 - \text{percentage concentration})]$ . For example, if the ownership is 5%, then the logistic transformation will yield -1.28. Squaring that transformed number will give 1.64. Such transformation is made to convert an otherwise bounded dependent variable into an unbounded one. Demsetz and Lehn repeated the same logarithmic transformation for the top 20 largest shareholders to construct an index of ownership concentration.

A more recent study by Anderson and Reeb (2003) shows that, during the period 1992 through 1999, over 35% of the 403 non-utility, non-banking firms of Standard & Poor's 500 Industrial firms have concentrated family ownerships<sup>2</sup>. Even if the family does not have predominant majority ownership, the family control of board seats is 2.75 times greater than the family's equity stake would imply (*ibid*, 2003, p. 1302). On the other hand, Ang, Cole and Lin (2000) study the non-listed firms in the U.S., using the Federal Reserve Board's 1997 National Survey of Small Business Finances (NSSBF). Their sample contains 1,708 small corporations (excluding partnerships and S-corporations)<sup>3</sup>. They find that 30.1% of their sample firms have 100% ownership by the primary owner. When ownership is relaxed to 50% or more by the primary owner, the percentage jumps to 58.6%. When the ownership is further relaxed to a single family (rather than the primary owner) that owns more than 50% of the firm, the percentage increases to 73.1%. This indicates that it is not rare for concentrated ownership or a significant shareholder to prevail in either large-capitalized or small-capitalized firms in the U.S. As regards the ownership structure in non-U.S. firms, it will be discussed in the following section, Section 3.2.2.

### **3.2.2 Ownership structure of firms outside U.S.**

La Porta, Lopez-de-Silanes, and Shleifer (henceforth referred as LLS, 1999) carry out a comparative cross-country study covering the richest 27 countries in the world (based on 1993 per capita income) excluding Kuwait, United Arab Emirates, Saudi Arabia and some countries that do not have significant stock markets. From each of these 27 developed countries, LLS select the 20 largest publicly listed firms based on market capitalization of the firms' common equity as at end 1995 and construct a sample of large firms. Similarly, they select the smallest 10 firms with market capitalization of common equity of minimum USD 500 million from each country to form a sample of medium firms. After deleting banks, utilities companies, affiliates of foreign firms, and those firms that are wholly

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<sup>2</sup> Anderson and Reeb define family firms as firms where the family continues to have an equity ownership stake or board seats. By such definition, they have 141 Family Firms and 262 Non-family Firms in their sample. Moreover, eight firms from the founding families group exit in the course of the sampling period, causing the firm's designation to change from Family to Non-family. The mean family ownership (%) of equity in their sample for Family Firms is 17.88% (Non-family firms: 0%). The officer and directors ownership (less family) for Family Firms has a mean of 1.35% (Non-family firms: 1.45%). They acknowledge that the level of control exerted by family owners may not be directly proportional to the level of ownership by the family owners.

<sup>3</sup> S-corporations in the U.S. are not subject to corporate taxation. The owner-managers of S-corporations may have incentives to compensate themselves in the form of partner distributions or dividends rather than salary because there is no double taxation of such earnings at the firm level (Ang, Cole, and Lin, 2000, p. 85)

owned by the state, LLS arrive at a sample of 691 firms (out of a possible total of 810 firms), and measure the average ownership patterns for each country. Using a threshold of 20% voting rights as the definition of control, LLS find that 36% of their sample firms are widely held, 30% are family-controlled, 18% are state-controlled, and the remaining 16% are controlled either by a widely-held financial institution, by a widely-held corporation, or miscellaneous. From their empirical finding that only 36% of the firms in the richest countries are widely held, LLS conclude that Berle and Means' (1932) perception of diverse ownership is misleading: diverse ownership only exists in the U.S., the U.K. and, arguably, in Japan. In the rest of the world, there are hardly any widely held firms. In contrast, concentrated ownership prevails; and among those firms with concentrated owners, the most common owner types are the families, followed by the state.

LLS's global investigation of concentrated ownership is consistent with the findings of regional but more in-depth studies. For example Faccio and Lang (2002) examine 5,232 listed firms in Western Europe (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland, and the U.K.) from 1996 to 1999 (approximately 94% of the total listed firms in these 13 countries) and find that the ownership is polarized: firms are either widely held (37%) or family controlled (44 %). Broadly speaking, their findings indicate that financial firms and large firms are more likely to be widely held, whereas non-financial and small firms are more likely to be family owned and controlled. In Continental Europe (Austria, Belgium, Germany, and Italy), Krivogorsky (2006) reports that more than half of listed industrial firms have majority stockholders who own at least 50% equity of the company.

In Australia, Craswell, Taylor and Saywell (1997) report that ownership varies according to firm size. Comparing small firms (with mean market value of A\$ 2 million) and large firms (with mean market value A\$ 1.4 billion), directors' ownership (i.e., insiders' ownership) of small firms is considerably higher (35.2% mean insider holdings) than that of large firms (7.1% mean insider holdings), based on a sample of 95 large firms and 91 small firms listed on the Australian Stock Exchange as at June 30, 1989. Craswell *et al* report that institutional ownership is a common feature for firms in Australia, which is not the case in other countries in Asia. In addition, it is note-worthy to report that, according to LLSV's (1998) cross-country survey on the rule of law, Australia scores 10.00 (the highest) in both the Efficiency of Judicial System and the Rule of Law. Australia's scores are higher than Singapore's and Hong Kong's among the English common-law legal regimes.



In fact, Australia's scores are even higher than Japan's, a country that has a German-origin legal system. In sum, Australia is very close to U.S. and U.K. in terms of firm ownership structure and external corporate governance environment, and is distinct from other East Asian countries which are characterised by family ownership.

In East Asia, corporations are often characterized not only as family-owned but also family-controlled (Claessens, Djankov, Fan, and Lang, 1999; Claessens, Djankov and Lang, 2000). Both studies by Claessens *et al* report extensive family ownership and control in more than half of East Asian companies, and that more than two-thirds of firms as at the end of fiscal year 1996 are controlled by a single shareholder through cross-holdings and pyramid structure. Moreover, managers of closely held firms tend to be relatives of the controlling shareholder's family. Claessens *et al*'s findings are based on 2,980 publicly traded companies in nine East Asian countries that include Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand.

Other research studies confirm the concentrated ownership either by insiders, by families, or by the state, in Asian corporations. For instance, in the global ownership study by La Porta, Lopez-de-Silanes, and Shleifer (LLS, 1999 p. 481), they examine 4 Asian countries, namely, Hong Kong, Japan, Singapore, and South Korea. Based on a classification of 20% voting rights as effective control over a firm, LLS find that listed firms in Hong Kong are predominantly owned and controlled by families through pyramids, management appointments, cross-ownership, and the use of shares that have more votes. In Korea, the large corporations are controlled by *chaebols* (i.e., business groups) through pyramids and cross-holdings, even though the largest shareholder of the firms is a family who does not own more than 20% voting rights of the firms. In contrast, about half of sampled firms in Singapore are controlled by the state. Only in Japan do they find firm ownership is more diverse.

Country by country, there are some variations in the concentration of family ownership within East Asian firms. For example, Claessens, Djankov and Lang (2000) report that the largest 10 families in Indonesia, the Philippines, and Thailand control half of the corporate assets in their sample; whereas the largest 10 families in Hong Kong and Korea control about one third of the corporations in their respective countries. LLS (1999, p.481) report an example of the predominance of family ownership in Hong Kong by the Li Ka-Shing family that owns and controls three of the 20 largest companies. One of them is Hutchison

Whampao, which is the second largest employer in Hong Kong after the Hong Kong SAR Government. In Thailand, Wiwattanakantang (2001) documents that 80% of non-financial firms listed on the Stock Exchange of Thailand are family-owned. In Taiwan, Yeh, Lee, and Woidtke (2001) examine 208 listed companies in 1993 and find that approximately 76% of the sample firms are family-controlled, 17% are widely held and the remaining 7% are controlled by the state, a diffusely held corporation, or a foreign investor. A common characteristic among Indonesia, the Philippines, Thailand, Taiwan, and Hong Kong is that a large Chinese business community is present and is playing an influential role in each economy. However, only in Hong Kong is the family ownership high *and* a common law system practised.

In Korea, controlling shareholders and their families own an average of 32% of the shares of publicly listed firms, that is, less than one third of the stockholding. By means of interlocking ownership and formation of business groups (*chaebols*), these families are able to maintain their control over the firms without having a majority shareholding (Lim, 1989; Joh, 2003). On the other hand, Japan seems to have relatively the most widely dispersed non-family ownership among all Asian countries. Prowse (1992) reports that, though ownership is highly concentrated in Japan, financial institutions are by far the most important large shareholders because banks are legally permitted to hold substantial stakes of the corporations. Management shareholding is less important (*ibid*, 1992, p. 1126).

In summary, dispersed ownership of firms is far less common outside the U.S. and U.K. Firms in Europe and Asia often have controlling shareholders. In Asia, except in Japan where banks and financial institutions are the largest shareholders, firm's ownership tends to be concentrated in families or controlled by business groups interlocked with families. When ownership is more likely to be concentrated than diffused, the agency problems arising from the separation of ownership and control (Jensen and Meckling, 1976) may no longer be as severe as another type of problem – the entrenched management problem – when the managers obtain more and more voting rights of the firm (Morck, Shleifer and Vishny, 1988; and Stulz, 1988). Shareholders' concern on the corporate governance practices of a family-owned firm may differ from those of a firm whose ownership is dispersed. For instance, outside minority shareholders may be apprehensive about the potential expropriation by the majority shareholders (also known as *tunnelling* as suggested by Johnson, La Porta, Lopez-de-Silanes and Shleifer, 2000), who usually

appoint delegates to either sit on the board or as managers to run the day-to-day operations of the firm. This apprehension will be even stronger where firms are family-owned.

In the case of Hong Kong where family ownership is prevalent and the duality of the CEO and Chairman is commonplace, the nature of the agency problem and the minority shareholders' concern for corporate governance will be significantly different from those in other Asian countries, and hence merits investigation and analysis. On the other hand, the common law legal origin and the strong legal protection environment of Hong Kong (as reported in LLSV, 1998) makes Hong Kong a distinct market for testing how well the corporate governance mechanisms, installed at firm level voluntarily, can protect outside investors' interest and hence affect firm valuation in the face of concentrated ownership by the insiders (i.e., family members). This study uses Hong Kong listed firms as the subjects for investigation.

Section 3.2.3, which follows, will focus on the managerial ownership of a firm, and discuss how it is related to the control of a firm, and thus necessarily affecting the corporate governance of a firm in response.

### **3.2.3 Managerial ownership and control**

In this study, 'managerial ownership', 'management ownership', 'directors' ownership', and 'insiders ownership' are used interchangeably to mean the equity ownership of a firm held by the management, who are the insiders including managers and directors, either directly or indirectly.

*Direct* ownership, according to the U.S. Securities and Exchange Commission (SEC), means that the individual shareholder holds title to the shares, has the voting rights associated with the shares, and receives any pecuniary benefits of share ownership such as dividends and capital gains. On the other hand, *indirect* ownership refers to the scenario where the individual does not personally hold title to the shares but exercises some control over the voting rights associated with those shares. However, the individual may or may not receive any pecuniary benefits of the shares (Holderness, Kroszner, and Sheehan, 1999).

Extending the theoretical work by Berle and Means (1932) and Jensen and Meckling (1976) on the agency theory of the firm, Fama and Jensen (1983b) argue that the key factor for modern firms to survive lies in the separation of ownership and control. While 'ownership' of a firm leads to the risk-bearing functions of the shareholders, the 'control' of a firm is vested in the decision-making functions of the managers who offer the benefit of specialization in management skills. An implication of such separation is that those who are in control of a firm may not necessarily bear a substantial share of the wealth effects of their decisions which are important to the firm's owners (*ibid*, p. 301).

In view that the separation of ownership and control of a firm can give rise to corporate governance problems, the ability to align management's (i.e., insiders) and shareholders' (i.e., outsiders) interests via the ownership of equity becomes an important topic of inquiry. In a survey of 4,200 public U.S. firms, Holderness, Kroszner, and Sheehan (1999) find that management's ownership in the U.S. firms in 1995 is higher than it was in Berle and Means's (1935) time. This is rather surprising because large share holdings – especially majority ownership – are relatively uncommon in the U.S. Greater management ownership in the 1990s is attributable to the widely used incentive-alignment devices such as executive stock options, pay-for-performance compensation, etc. for executives' remuneration packages. It is also believed that the popularity of company options has contributed to the ease and increase of managerial ownership in the U.S.

In contrast, large ownership is common outside the U.S. A review study by Shleifer and Vishny (1997) documents that East Asian firms typically have controlling owners, who are often founders of the firm or their offspring (*ibid*, p. 755). Theoretically, large shareholders govern firms by exercising their voting rights as vested by their shareholding rights, which are grounded in the degree of legal protection in that country. Provided the 1-share-1-vote voting mechanism is practised and assuming the large shareholder exercises such voting right, a majority owner can dictate the decisions of the firm (*ibid*, p. 755). Such decisions may include appointment of family members to the board as directors and/or employment of family members as managers, if the large shareholder has a majority equity ownership (i.e., >50%).

Control over a firm need not arise from concentrated ownership by a single, majority shareholder, however. Concentrated control can be exercised by closely-knit families or affiliated parties. La Porta, Lopez-de-Silanes, and Shleifer (1999) study the control

structure of the largest 20 listed companies each in 27 developed countries including 4 East Asian ones (Hong Kong, Japan, Korea, and Singapore). They find that listed companies in Hong Kong are predominantly controlled by families through pyramids, management appointments, cross-ownership, and the use of shares that have more votes than the regular 1-share-1-vote system.

In Asia, the widespread use of *pyramidal ownership structures* and *cross-holdings* provides the insiders with great opportunities to exercise effective control of a firm to a far greater extent than the insiders' cash flow rights may warrant (Claessens, Djankov, and Lang, 2000). In their study of 2,980 firms in nine East Asian countries including Hong Kong, Claessens *et al* find extensive family control in more than half of East Asian firms and that separation of management from ownership control is rare. Specifically, in Hong Kong, 73% of the largest 20 firms are under family control, while 66% of the median 50 firms and 57% of the smallest 50 firms are controlled by family (*ibid*, 2000, p. 106).

Lins (2003) reports that, in his sample of 1,433 firms from 18 emerging markets including Hong Kong, on average 50% of a firm's control rights are held by 5% (or greater) block-holders.<sup>4</sup> Lemmon and Lins (2003) document that, of their sample of 800 firms across eight East Asian countries including Hong Kong, the average control right held by the insiders is 26%. However, the average of the cash-flow rights leverage is 2.17<sup>5</sup>, meaning that the insiders can turn one cash-flow ownership into over two control rights. They conclude that such separation of ownership and control significantly increases the potential for managerial agency problems and the risks of tunnelling by the majority shareholder. The *quality* of corporate governance, in as much as it is meant for regulating the relationship among various stakeholders of the firm, is therefore a necessary factor in assessing how the ownership structure may affect the firm's value.

Hong Kong listed firms are the subjects of analysis in this study. Since a lot of Hong Kong firms are both predominantly owned *and* controlled by families (which is commonplace in Asia except Japan and Singapore), those firms may face different types of agency problems

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<sup>4</sup> The 5% ownership threshold as block-holding is commonly used by American researchers because it corresponds to the definition of block-holding of the U.S. Securities Exchange Act (Rule 13d-1(a)). In the U.K., stock holding of 5% or more (subsequently changed to 3% or more from 1990) of stock in a public company must be disclosed within 5 days (2 days from 1990) of the holding. Also, Denis & Sarin (1999) argue that changes in ownership of 5% or more are large changes and are economically meaningful.

<sup>5</sup> Cash-flow rights leverage is defined as the ratio of the management control rights divided by management cash-flow rights. If it is one-share-one-vote system, the cash-flow rights leverage should be equal to 1 (Lemmon and Lins, 2003, p. 1451)

from what Jensen and Meckling (1976) postulated (see Section 3.2.4 below). To the minority shareholders and outside investors, the problem of manager's shirking (Stulz, 1988) may not be as pertinent as the problems of entrenchment of incompetent managers (Demsetz, 1983), or the potential risks of tunnelling by predominant shareholders (Johnson, La Porta, Lopez-de-Silanes and Shleifer, 2000). Outsiders face an information asymmetry problem with managers (i.e., insiders), and they may have difficulties in monitoring those managers who are closely related to the predominant shareholders of the firm. This conflict between the minority outsiders and the controlling insiders cum managers is a kind of agency problem different from what Jensen and Meckling (1976) had described in their study, hence should call for another perspective for the analysis of corporate governance. The following section discusses the relationship of ownership and corporate governance problems of a firm.

### **3.2.4 Ownership structure and corporate governance problems**

When managers have only a fraction of firm ownership, agency problems seem to abound. Jensen and Meckling (1976) suggest that more management ownership should help align the manager's interest with the shareholders' interest. However, when managers have predominant ownership (i.e., > 50%), other types of corporate governance problems may creep in. A series of possible problems may include: excessive executive perks, entrenchment of incompetent managers, transfer of assets and profits out of firms for the benefit of the predominant shareholders (i.e., tunnelling, as posited by Johnson, La Porta, Lopez-de-Silanes and Shleifer, 2000), self-dealing transactions such as lucrative executive compensation, empire building, loan guarantees offered to the predominant shareholders, and investing into projects that bring more personal benefits to the managers rather than those with maximum net present value. These problems – which strictly speaking are corporate governance problems rather than agency problems – arise as the managers are now closer to being the principals than the agents, and may take on other forms. For example, predominant shareholders can expropriate minority shareholders' interests by dilutive share issues. Other CG problems may take place in minority freeze-outs, insider trading, or other financial transactions that discriminate against minority shareholders. When there is a predominant shareholder in a firm, the protection of minority shareholders' right becomes the focal point of corporate governance issues.

Various mechanisms have been proposed in extant CG literature to curb agency conflicts and limit agency costs. The mechanisms can be broadly classified into internal and external CG mechanisms as previously discussed in Chapter 2 of this study. While the external mechanisms may be applicable to all firms operating within the same economy, the internal mechanisms may vary from corporation to corporation. One of the objectives of this study is to examine whether the internal CG mechanisms of a firm, and the voluntary disclosure of a firm's CG practices, would affect the firm's valuation in the same economy where the external corporate governance mechanisms are assumed to apply equally well to all firms and investors alike. The following section, Section 3.2.5, will turn to discuss the relationship between ownership structure and firm performance, which has been the focus of research work of many CG studies.

### **3.2.5 Ownership structure and firm performance**

Empirical studies have not been able to provide unambiguous evidence on the relationship between ownership structure and firm performance (Andres, 2008). The following discussion reviews the extant literature on this relationship and aims at explaining why a direct linkage between ownership structure of a firm and its performance is inadequate, and hence leading to inconclusive findings, if the firm's corporate governance is missed out.

Demsetz (1983) argues that a firm's ownership structure should have no relation with its performance. The ownership structure should be thought of as an endogenous result of decisions of shareholders and the trading of shares on the market. He explains that when shareholders of a listed firm agree to a seasoned offering, they are in effect deciding to alter the ownership structure of their firms. By the same reasoning, when a private firm decides to become a public, listed, firm through initial public offering (IPO), the owner(s) may have also agreed to change the ownership structure. Implicitly, an agreement to make the ownership structure more diffuse is present. Any subsequent trading of shares after the IPO signifies a desire of potential and existing owners to change the ownership stakes and hence the ownership structure of the firm.

In Demsetz's (1983) argument, the observed level of a firm's equity ownership by insiders and firm performance is the outcome of some market forces such that each firm attains its own optimal ownership structure for that firm. Changes in ownership cannot be used to enhance corporate value. Any observed cross-sectional empirical relation between the level

of insider share ownership and firm performance must be spurious. Demsetz and Lehn (1985) and Demsetz and Villalonga (2001) use panel data studies to provide empirical evidence of the endogeneity of a firm's ownership structure argued for by Demsetz (1983).

In contrast, cross-countries studies have shown that ownership structure has a close relationship with firm performance and firm valuation. Morck, Shleifer, and Vishny (1988) investigate the relationship between management ownership and market valuation of the firm (as measured by Tobin's  $q$ ) for 371 Fortune 500 firms in 1980. They find a curvilinear relationship that depicts an initial increasing  $q$  as the percentage of director ownership increases, but a decreasing  $q$  when insiders' ownership lies between 5% and 25%. However, when ownership increases further from 25% onwards, Tobin's  $q$  rebounds as a positive function of insiders' ownership. Morck *et al* interpret the increases of  $q$  as a convergence of interests between managers and shareholders, while the decline reflects entrenchment effect of the management.

Using the results of two insider ownership surveys of U.S. firms in 1976 and 1986, McConnell and Servaes (1990) find that the insider ownership (defined as equity owned by members of the board of directors *and* by corporate officers) has an alignment effect which dominates the entrenchment effect up to 25% managerial ownership. After that, the entrenchment effect dominates the alignment effect and firm value begins to diminish.

McConnell and Servaes's (1990) study is extended by Short and Keasey (1999), who use U.K. firms to document that the entrenchment effect threshold lies at 12% of managerial ownership (defined as the percentage of equity shares owned by directors and their immediate families, and by their ownership via corporate vehicles). A non-linear relationship is found between managerial ownership and an accounting performance measure (i.e., return on equity) as well as a market performance measure (i.e., market-to-book ratio of equity)<sup>6</sup> of the firm.

A study conducted in Australia – another country that also practises common law – by Craswell, Taylor, and Saywell (1997) indicates that the curvilinear relationship between managerial ownership and firm value is not conclusive, especially for small firms. There is

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<sup>6</sup> Short and Keasey use the log form of market-to-book ratio of equity to overcome the skewness in the distribution of such a measure. Following Leech and Leahy (1991), they name this measure as a valuation ratio (VAL) and argue that, in the U.K., it can be an approximation to Tobin's  $q$ . All intangible assets are excluded in this measure.



no evidence to support either the existence of a piecewise linear relationship reported by Morck, Shleifer, and Vishny (1988), or a simple linear relationship that resembles the findings of McConnell and Servaes (1990) for the large firms sample in 1989. Farrer and Ramsay (1998) find that, in some circumstances, a positive relationship exists, but the results differ according to some factors such as firm size, whether the managerial ownership is measured by dollar value, or the percentage of the shares outstanding, etc.

Himmelberg, Hubbard and Palia (1999) conduct a panel study on 600 U.S. firms from 1982 to 1984 to study the relationship between managerial ownership and firm performance. They regard managerial ownership as a choice of contractual arrangements between the firm and the managers. In Himmelberg *et al's* view, such choice as well as the firm's performance (as measured by accounting rates of return or Tobin's  $q$ ) is endogenously determined by some features of the firm's contracting environment which are only partly observed and exogenous (*ibid*, 1999, p. 381). Their panel study shows that a large fraction of the cross-sectional variation in managerial ownership is explained by unobserved firm heterogeneity (i.e., unobserved firm common characteristics). Himmelberg *et al* suggest that the common characteristics may include exogenous changes in the firm's contracting environment. Some characteristics are "unobservable to the researcher" (*ibid*, 1999, p. 356) such as a superior monitoring technology possessed by some shareholders, the proportion of intangible assets to a firm's total assets, or the degree of market power in terms of competitive product markets which can alter the contractual arrangements with the manager's compensation and may call for changes in the optimal level of management ownership. Himmelberg *et al* report no evidence that changes in managerial ownership affect firm performance. Their reported empirical results are not robust to controls for endogeneity induced by "time-invariant unobserved heterogeneity" (*ibid*, 1999, p. 381). Although they provide no evidence that changes in managerial ownership affect firm performance, they find a quadratic form of relation between insider ownership and performance when they control for endogeneity of ownership by using instrumental variables. They interpret their results as supporting the notion that a firm chooses among various mechanisms for minimizing agency costs.

Himmelberg *et al* (1999) assume that managerial effort is a random variable that is dependent upon year-on-year changes in managerial ownership, which justifies their panel data approach. The interpretation and methodology of Himmelberg *et al's* study are

challenged by Zhou (2001). First, Zhou points out that there are shortcomings in using a fixed effects estimation in their panel data study. It would be difficult to detect a meaningful relation between ownership and performance as the firm fixed effects have essentially removed all cross-sectional variations. Although a fixed effects model controls for unobserved heterogeneity specific to firms, the model is actually considering *changes* in ownership versus *changes* in value rather than *level* of ownership versus *level* of value. When changes are compared and used in the model, any firm fixed effect will cancel out. A firm fixed effects model essentially removes all cross-sectional variations. Any relation that remains cannot be said to be attributable to endogeneity that arises from such an effect.

Second, insider ownership typically changes slowly over years (Zhou, 2001, p. 560). For a typical firm in most years, there is no change in ownership at all whereas firm value can change dramatically over the course of a year for reasons totally unrelated to insider ownership. Zhou argues that it is not clear that small, one-year, changes in managerial ownership (e.g. due to a manager's exercising of his options) are indicative of the changes in managerial *incentives* that will lead to substantive within-year changes in firm performance, given that rational managers will always maximize the long-term interest of the firm. For example, Firm A's CEO owns 10% of her firm's stock while Firm B's CEO owns 0.1% of his own firm's equity. A 10% randomly across-the-board change of managerial ownership will lead to an observed ownership distributed between 9% - 11% for Firm A's CEO and 0.09% - 0.11% for Firm B's CEO. The range of difference of managerial ownership for Firm A is 2% points but for Firm B is only 0.02% point. If managerial ownership provides important incentives to managers to perform, one would expect a notable difference in the performance between the two CEOs, which is supposed to be reflected in their firm's performance (i.e., in line with the difference of 2/0.02 or 100 times). However, no meaningful within-year changes in either firm's performance may result.

Third, managers are expected to work for their firm for *some* years. As argued by Zhou, their incentive to perform is linked to the bonding between their long-term interest and the firm's expected long-term performance (Zhou, 2001, p. 560). Even if large managerial ownership over time does lead to better performance over time, its effect on performance would necessarily show up in cross-sectional tests and not necessarily discoverable by means of a panel data approach.

Fourth, Zhou states that the ownership-performance relationship observed in the ordinary least square (OLS) tests, while it disappears in the fixed effects regressions, becomes much stronger in the tests with instrumental variables (without firm fixed effects). If Himmelberg *et al's* (1999) methodology (i.e. fixed effects estimator and the use of instrumental variables) is able to solve the endogeneity problem arisen from unobserved firm heterogeneity, one would expect the tests with instrumental variables to improve upon the OLS tests estimator *in the same direction* as with the fixed effects estimator. However, this does not turn out to be the case with their results. On the contrary, when Himmelberg *et al* use instrumental variables (without firm fixed effects), they obtain results that improve significantly upon the OLS tests. This is at odds with their own conclusion that the ownership-performance relationship is likely to be a spurious correlation due to an endogeneity problem (Zhou, 2001, p. 563). Therefore, Zhou concludes that changes in managerial ownership alone do not reflect changes in total equity incentives. Manager's behaviour is not likely to change in response to small and temporary changes in ownership stakes and result in detectable within-year effects on firm performance. Year-to-year changes in ownership would not convey much information on changes in managerial incentives although the cross-sectional differences in CEO ownership are extremely large. As such, using panel study based on a firm fixed effects estimator may not be ideal for analysing the relationship between managerial ownership and firm performance.

Haniffa and Hudaib (2006) conduct an empirical study on the corporate governance structure and performance of 347 Malaysian listed companies from 1996 to 2000. They find that there is a significant *negative* relationship between a firm's managerial shareholding and the firm's accounting performance in a country with high concentrated ownership and no separation between dominant family owners and managers. They interpret the result as supporting Himmelberg, Hubbard and Palia (1999) that both managerial ownership and firm performance are endogenously determined by common characteristics.

In examining the factors impacting on firm performance, both Haniffa & Hudaib's (2006) and Himmelberg *et al's* (1999) studies have not considered the dividend payout. Dividend payout can be an effective corporate governance tool in monitoring the managers' performance and in mitigating agency problems in a firm, as proposed by La Porta, Lopez-de-Silanes, Shleifer and Vishny's two agency models of dividends (LLSV, 2000b). This thesis also examines the relationship between the dividend payout of a firm and its

voluntary CG disclosure. It aims to test whether LLSV's models apply in an economy already benefiting from strong investor protection by a strong legal regime, but is characterised with concentrated ownership. A more detailed discussion of LLSV's agency models of dividends will be presented in Section 3.2.6 and Chapter 4.

A recent study by McConnell, Servaes, and Lins (2008) on 4,141 cases of the insiders' purchases of the shares of firms (representing 1,700 different U.S. companies) from 1994 to 1999 measures the announcement period abnormal return for each insider's purchase. They find a curvilinear relationship exists between insider ownership and firm value as documented by McConnell and Servaes (1990, 1995). McConnell *et al* (2008) interpret their empirical results as that insider ownership can be used to increase firm value up to a point, after which additional ownership actually reduces firm value. They maintain that their interpretation does not necessarily refute the existence of an optimal ownership structure but they challenge the notion that all firms are at their optimal ownership structure all the time. They conclude that changes in share ownership by insiders can and do affect firm value.

The findings from the above-mentioned studies indicate that the relationship between managerial ownership and firm performance – both in terms of accounting and market measures – is not likely to be a linear one. There is an implication that aligning the diverse interests of management and shareholders is not a simple case of providing management with larger and larger stakes in equity as suggested by the agency theory. The firm's value may be affected by the CG mechanisms and practices of the firm. Corporate governance needs to be considered when the relationship between ownership structure and firm performance is examined. The following section, Section 3.2.6, reviews the prior studies on the relationship of dividends and a firm's ownership structure. It also discusses the roles that dividends can play in a firm's corporate governance.

### **3.2.6 Ownership structure and dividend payout**

If dividends are a direct result of a firm's performance and if a firm's performance is affected by a firm's ownership structure from the corporate governance point of view (Jensen and Meckling, 1976), then ownership structure should have an impact on dividend payout. Classical financial theorists often relate dividends to the market valuation of a firm (e.g., Lintner, 1956; Bhattacharya, 1979; Miller and Modigliani, 1961; Miller and Rock,

1985), which may be affected by a host of variables including the firm's ownership structure and corporate governance. In contrast, La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV, 2000b) extend Easterbrook's (1984) view that dividend policies can address agency problems. They argue that dividends have a governance role to play. They postulate two models for dividends: the outcome agency model and the substitution model. The outcome agency model suggests that in a circumstance where investors are well protected by the law, the shareholders are willing to accept low dividend payouts in the short-term from a high-growth firm in order to give the firm a high re-investment rate. Shareholders agree to a low dividend rate in the short-term so that when the investments pay off, they can extract high dividends because the law can provide assurance that this will be so. Firms therefore can afford to pay a low dividend payout to the investors<sup>7</sup>.

On the other hand, the substitution model posits that in a weak legal protection environment where expropriation of shareholders can easily be achieved by insiders, the firms will be eager to establish a good reputation for moderation in expropriating shareholders in order to raise external funds from investors. Paying higher dividends is one way to establish such a reputation. Other things being equal, firms with better growth prospects tend to have a stronger desire for the reputation because they have stronger need for external finance. It follows that firms in a weak legal regime but with good growth prospects will choose to pay higher dividend payouts than firms with poor growth prospects (more detailed discussion on LLSV's (2000b) dividend models will be presented in Chapters 4 and 6). LLSV's (2000b) theoretical models remain to be empirically tested, and one of the objectives of this study is to test whether a strong legal investor-protection regime is sufficient to warrant a low dividend payout, when a high concentration of ownership prevails.

Farinha (2003) uses U.K. data and find a strong U-shaped relationship between insider ownership and dividend payouts. He finds that when the insider ownership reaches 30% and beyond, the coefficient on dividend payouts in his regression model changes signs from negative to positive. That means, as insider ownership reaches 30% or higher, there is a beneficial effect of a higher dividend payout. Farinha concludes that his findings are consistent with the managerial entrenchment perspective. His findings also suggest a critical management entrenchment level appears in the region of 30% insider ownership for

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<sup>7</sup> A good example to illustrate is Microsoft Corporation, which in its initial years did not pay high dividends, if any at all, to its shareholders despite high profitability. Microsoft is domiciled in the U.S., generally regarded as a country offering strong legal protection to investors.

U.K. firms. Below the entrenchment level, insider ownership and dividend policies can be seen as *substitute* corporate governance devices, hence leading to a *negative* relationship between these two variables. Above that critical entrenchment level, further increases in insider ownership are linked with additional entrenchment-related agency costs. Dividend policy may become a *compensating* monitoring force as a result. Accordingly, a *positive* relationship with insider ownership would be predicted. This entrenchment effect is distinctive from other competing dividend policy theories (e.g., tax clienteles theory, signalling-of-future-income theory) in that a U-shaped relationship between insider ownership and dividend payout is predicted.

Mitton (2004) finds empirical support for LLSV's (2000b) outcome agency model of dividends for firms operating in emerging markets. The outcome agency model states that dividends are the result of the implicit demand from minority shareholders who would use their ownership rights and power to extract dividends from the firm. However, Jiraporn and Ning (2006) find empirical support for LLSV's (2000b) substitution model of dividends in monitoring the agency problems in another study of 3,732 firm-years data on U.S. firms. They find that the strength of shareholder rights does affect dividend payouts in a negative way, that is, firms with more restricted shareholder rights pay higher dividends. Jiraporn and Ning attribute the difference of their findings from those of LLSV's to the strong legal system of minority shareholders protection in the U.S, whereas LLSV's study examines dividend policies across disparate legal regimes in the world.

The research studies, mentioned above, attempt to find out the effect of a firm's insider ownership on the dividend payout to investors. In the course of testing LLSV's (2000b) two dividend models in the real world, researchers find that dividend payout can be a tool employed by the insiders to alleviate investors' worries if an entrenchment problem is perceived to exist. LLSV (2000b) propose the use of dividend payout as a means to curb agency problems and to supplement a firm's corporate governance mechanisms. It becomes an empirical issue to test how dividend payout is related to the firm's state of corporate governance, subject to the various levels of ownership structure and degrees of ownership concentration, controlling for the impact of external corporate governance and other firm characteristics. The above-mentioned studies indicate that ownership structure and corporate governance may have different strengths of relationship, depending on the market's level of legal protection and the extent of family concentrated ownership. To conduct an analysis of concentrated family ownership and corporate governance of firms in

a strong legal protection system will fill a gap in the above studies. A study on the firm's ownership structure, corporate governance, dividend payouts, and their relationship with the firm's valuation, using listed firms in Hong Kong where ownership is highly concentrated, will add to extant literature and provide informational comparison. The following sub-section will discuss the possible impact of ownership concentration on a firm's performance.

### **3.2.7 Ownership structure and firm performance**

Prior literature has shown that firm performance is contingent upon the country and upon the concentration of ownership. Empirical evidence is provided by Claessens, Djankov, Fan, and Lang (1999) on firm performance and block-holder's identity of the firm's ownership in East Asia; Claessens and Djankov (1999) on the relationship between profitability and ownership concentration of Czech firms; and Lins and Servaes (1999) on the diversification value and concentrated ownership of firms in Germany, Japan, and U.K. Chen, Cheung, Stouraitis, and Wong (2005) study family ownership and firm performance based on 412 listed Hong Kong firms during 1995-1998. They find no positive relationship between family ownership and market-to-book ratio (a proxy for the firm's valuation). Their findings support Demsetz and Lehn (1985) and Himmelberg, Hubbard, and Palia (1999) that concentrated ownership is not necessarily associated with better operating performance or higher firm valuation.

However, Chen *et al's* (2005) study shows that there is a negative relationship between firm performance and the dual roles of Chairman/CEO, providing evidence consistent with managerial entrenchment problem in firms that combine the positions of CEO and chairperson of the board for Hong Kong firms. Their findings open a possibility for further research on the *combined effect* of ownership structure and other corporate governance attributes on a firm's performance; or that a firm's performance may be affected by the firm's ownership structure *subject to* the operation of internal corporate governance structure and practices.

This study focuses on Hong Kong firms, which are characterised by concentrated ownership by families. A family-owned firm, like all other firms, may need external capital to finance its future investment projects. It needs access to wider sources of capital and lower costs of capital for expansion. On the other hand, outsider investors are expected to

avoid financing a firm that is run by the insiders when most of whom belong to the same family without a sound, fair, and equitable corporate governance (CG) structure being installed. For firms operating in an economy where there is weak legal protection for minority shareholders, a reputation for treating minority outside investors fairly and equitably is all the more valuable (LLSV, 2000b, p.7). If a family-owned firm desires to establish a good reputation or protect its good name of fairness to the non-family outside investors, the managers will be expected to signal their intention to the market. One of the ways to achieve a good reputation is to implement a more comprehensive set of CG structure, disclose more voluntarily about their CG practices, and provide more information to the market than what the other firms are doing. If this is the appropriate strategy for a family-owned business in a weak legal regime to adopt for achieving a good reputation, the same strategy may arguably be applied by family-owned businesses in a strong legal protection regime such as Hong Kong. It is the firm-level managerial decision to voluntarily disclose that matters.

The empirical study by Chen, Cheung, Stouraitis, and Wong (2005), reports evidence to support this argument. Chen *et al* examine 412 listed firms in Hong Kong from 1995 to 1998 (representing about two-thirds of all firms listed in 1998). During the period of study, the Listing Rules of the Hong Kong Exchange did not require firms to disclose information on their CG structure. Chen *et al* select some attributes of the firm's internal CG structure and practices such as board size, the presence of Independent Non-Executive Directors (INEDs); setting up of audit committee; requirements of separating the roles of the Chairperson and CEO; and the disclosure of the attendance record of members of the audit committee, etc. They find a significantly *negative* relationship between the CEO/Chair duality and the firm's market-to-book ratio. They also find a significantly *positive* relationship between the board size and the firm's market-to-book ratio. At a time when information about a firm's CG practise was scarce, such disclosure to the outsiders could be significant in affecting the firm's valuation.

This study aims at filling the gap in prior research such as that of Chen Cheung, Stouraitis, and Wong (2005) by examining how a firm's valuation is affected by concentrated family ownership and voluntary disclosure of corporate governance practices, within a legal environment that offers a high protection to outside minority shareholders such as Hong Kong. The Hong Kong Exchange enforced the mandatory disclosure of CG information in a formal Corporate Governance Report by firms starting January 1, 2005. This study



differs from previous research (in particular the one by Chen *et al* 2005) in that it studies the impact of *voluntary* CG disclosure on the valuation of a firm. Unlike Chen *et al's* (2005) work which examines the attributes of a firm's CG selectively, this study is interested in the extent of disclosure made by the firms with regard to an overall recommended CG structure and desirable CG practices, which had been made known to the listed firms in full by the Hong Kong Exchange since 2003 and up to 2005 (more discussion on sample selection is presented in Chapter 8). This study covers the time period from 2003 to 2005, immediately before the CG disclosure was made mandatory under the new Listing Rules which became effective in January 2005.<sup>8</sup>

This study also differs from Chen *et al's* research in that it comprises listed firms domiciled in Hong Kong, with their sole markets being Hong Kong or their business activities mainly carried out in Hong Kong. In contrast, Chen *et al's* sample contains firms with their main business activities and/or markets in mainland China, which opted to be listed on the Hong Kong Exchange. They are usually state-owned and are often large-capitalized firms. They have representatives from the State Department (usually bureaucrats) sitting on the board of directors, and may pursue corporate goals different from those profit-oriented ones of publicly-owned enterprises. Because of their special ownership structure and firm characteristics, these firms may exhibit different types of agency problems and implement different CG practices. This study will exclude such firms from the sample so that the real impact of voluntary CG disclosure on the valuation of the firm can be detected. The following section, Section 3.2.8, will discuss the relationship between ownership structure and voluntary disclosure by the firm.

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<sup>8</sup> The consultation period for the formal Corporate Governance Report ended in September 2004. On 19 November 2004, the SEHK (the holding company of the Hong Kong Exchange) published *the Conclusions on Exposure of Draft Code on Corporate Governance Practices and Corporate Governance Report*. For the purpose of implementing the *Code*, amendments were made to the Main Board Listing Rules which became effective on 1 January, 2005. However, as regards the *Corporate Governance Report*, there had been disputes between the SEHK and the listed firms on the contents of disclosure, particularly on the part of internal control system, on the grounds that the listed firms had insufficient expertise and time to set up the system as required by the new listing rules. Finally, the SEHK agreed to postpone the implementation of mandatory disclosure of the internal control system for six months, i.e., it became effective for accounting periods commencing on or after 1 July 2005 (HKEx, *Analysis of CG Practices Disclosure in 2005 Annual Report*, 2007, p. 1). Only 139 (equivalent to 27%) of the listed firms on the Main Board were found to have complied with the code provisions for the whole accounting period (i.e., January to December, 2005), and 73% of the issuers on the Main Board not complying with the *Code* to the full (*ibid*, 2007, p.2). In effect, the disclosure in the Corporate Governance Reports by the listed firms for their 2005 fiscal year remains largely voluntary.

### 3.2.8 Ownership structure and voluntary disclosure

Jensen and Meckling's (1976) agency theory predicts that as the manager's share of ownership falls, there is an increased likelihood that the manager will consume perks and maximize self-interests (rather than owner's interests). Outside shareholders are therefore expected to increase their efforts in monitoring the manager's behaviour, which will be costly. To reduce the monitoring costs of the outside shareholders on the firm, the manager is expected to make voluntary disclosure of the firm's information to the outside shareholders. Leftwich, Watts, and Zimmerman (1981) apply this reasoning to analyse the interim reporting by U.S. firms in 1948, when interim reporting was still voluntary. They find associations between the firms' use of monitoring devices (such as interim reporting) and their asset and capital structures, although the results are not strong.

Ownership structure of a firm has been found to have influence on a firm's practice of voluntary disclosure to the outside shareholders. Ruland, Tung, and George (1990) show in their empirical study that ownership structure, absolute errors of analysts' forecasts, and new capital offerings are significant factors that motivate firms to disclose their earnings forecasts. Ruland *et al* also find that ownership structure is the most important factor that distinguishes firms providing voluntary disclosure of earnings forecasts from those firms similar in size and industry but do not disclose.

Eng and Mak (2003) study the disclosure behaviour of 3 types of ownership: managerial ownership, block-holder ownership and government ownership. Using 158 listed firms on the Stock Exchange of Singapore in 1995, they find that firms with lower managerial ownership and firms with significant government ownership are associated with increased voluntary disclosure. However, total block-holder ownership is not related to disclosure. Furthermore, an increase in outside directors reduces voluntary disclosure. The findings are consistent with the substitution effect between outside directors' appointment and the need for voluntary disclosure in monitoring managers: the increased presence of outside directors increases the independence of the board, thus reduces the need for voluntary disclosure by the managers. Eng and Mak also find that larger firms have greater disclosure. They also document that firms with lower debt disclose more information.

### 3.2.9 Section Summary

This section has discussed the ownership structure of firms in different parts of the world as reported by prior studies. Different ownership structures give rise to different agency problems for the firm. The empirical findings by these studies suggest that high insider ownership in a firm is associated with increased likelihood for entrenched management. On the other hand, a low insider ownership often prompts the outside investors to guard against the possible self-interest seeking actions by the managers instead of maximizing the firm's value. LLSV (2000b) posit that dividend payout can be used as a means for the outside investors to protect themselves from expropriation by the majority insider/managers, by exercising their voting rights for high dividend payout as a return for their investment under a strong legal protection regime. Dividend payout can also be used by good firms as a signal to assure the outside investors under a weak legal protection regime where minority shareholders' rights are not strongly upheld. Empirical findings by other researchers have established the relationship between dividend payout and ownership structure. Dividend payout has a close link with the governance of a firm.

Ownership concentration of a firm, specifically by members of the same family, has been a concern to minority outside investors due to the asymmetry of information between the outsiders and the insiders<sup>9</sup>. In order to reduce the worries of outside investors, managers are expected to use voluntary disclosure of information so that the costs of monitoring the insiders may be reduced. Prior research has found evidence that firm value is positively related to the increased voluntary disclosure of a firm's information. Voluntary disclosure of information is also found to facilitate a firm in obtaining easier access to external finance, more market liquidity for its securities, and a lower cost of equity capital (e.g., Diamond and Verrecchia, 1991; Botosan, 1997).

The potential agency problems arising from ownership structure and ownership concentration can be alleviated through the installation of effective internal corporate governance mechanisms within the firm. The worries of outside investors for these agency problems can also be alleviated by the voluntary disclosure of the firm's CG practices. This study aims at finding out if voluntary disclosure of CG information would have an effect on the valuation of a firm, using Hong Kong listed firms as samples. Hong Kong firms are characterised with high concentration of ownership by families. This study will explore the impact of CG disclosure by family owned firms on their firm value. The

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<sup>9</sup> La Porta, Lopez-de-Silanes, and Shleifer (1999) state that family business is notorious for putting the interests of the family above the interests of other stakeholders of the firm.

following section, Section 3.3, discusses the characteristics of family owned firms. It also reviews the prior literature on family ownership of firms, and presents a theoretical background to the specific corporate governance issues arising from family-owned firms. An understanding of these issues will shed light on how to reduce the investor's concerns about their protection from expropriation by the majority shareholder, who more often than not is a family owner in the case of Hong Kong firms.

### **3.3 Family-owned firms**

One special type of ownership structure of firms is family ownership. In this study, family ownership means that the firm is mainly owned by a family and operated by the members of the same family (and related parties) on a day-to-day basis. Anderson, Mansi & Reeb, (2003) point out that family owners, being a large shareholder, have a strong incentive to decrease agency costs and increase firm value because usually their private wealth is invested in the company; and because their investments are not well-diversified relative to atomistic shareholders (Andres, 2008). The following section, Section 3.3.1, discusses the costs and benefits of this special type of ownership structure. Section 3.3.2 presents the factors that affect the evolution of family-owned firms into diffusely owned firms. Section 3.3.3 analyses the relationship between family-owned firms and their market value. Section 3.3.4 discusses the corporate governance of family-owned firms, followed by a summary in Section 3.3.5.

#### **3.3.1 Costs and benefits of family ownership**

There are potential costs and benefits of family ownership. On the positive side, family ownership offers less drastic changes in business strategies and practices than widely dispersed ownership. Family businesses tend to have a long-term commitment seeking to pass the firm onto their heirs; and survival of family business is usually a major concern for the family shareholders. Family firms tend to establish and rely on a reputation that helps foster trust and loyalty in the workplace, with the customers, and with the suppliers (Ward, 1988). As such, suppliers of capital such as bondholders and creditors are more likely to deal with the same governing bodies of a family business. They are familiar with the family's business practices for longer period, thereby willing to finance reputable family firms, especially those firms with founding-family ownership, at a lower cost of capital (Anderson, Mansi, and Reeb, 2003). Hence, good family-run firms tend to have easier access to external capital at a lower cost than firms with dispersed ownership.

On the negative side, there are potential costs associated with family ownership. Fama and Jensen (1985) point out that the combination of ownership and control might lead to sub-optimal investment decisions because the interests of the family are not necessarily aligned with outside shareholders. Entrenched family owners might have incentives to give up maximum profits (which benefit all shareholders) for private rents (which only the insiders can enjoy), thereby exploiting the minority shareholders (Faccio, Lang, and Young, 2001). Also, family-owned firms tend to elect family members to sit on the board of directors and assign executive positions to family members or their closely linked partners. Hence, the labour pool, particularly at the management level, is restricted to a very small group of people who have close connection with the owner family. This is quite common in the case of Chinese family-owned firms in Hong Kong.

As will be discussed further in Chapter 5 about the sample of Hong Kong firms in this study, 58.33% of the Small-Cap firms, 58.62% of the Mid-Cap firms, and 66.67% of the Large-Cap firms have two or more family members sitting on the board of directors as at 2005. It was the year when the firms were strongly encouraged to disclose the relationships, if any, of their board directors and key executives in their annual reports. Senior management of a firm with close connection with the owner family is a significant characteristic of family-owned business in Hong Kong. The entrenchment of these senior executives, even though they may not own directly a predominant shareholding of the firm, can be a potential CG problem, as will be further discussed in section 3.3.4.

### **3.3.2 Family-owned firms vs. diffusely owned firms**

Most firms start their life with high insider ownership (Helwege, Pirinsky and Stulz, 2007). As they develop and grow, some firms evolve to become diffuse in ownership but some retain a highly concentrated ownership by the insiders throughout their life span. At a particular point in time, insiders (or managers) own a larger fraction of shares in some firms than in others (Mikkelsen, Partch, and Shah, 1997; Denis and Sarin, 1999). Officers and directors of the firm are usually members of the same family. Using a probit model and a moral hazard model, Helwege *et al* (2007) follow all firms that completed an initial public offering in the U.S. from 1970 to 2001. They find that stock market variables play an extremely important role in the dynamics of insider ownership. First, they observe that firms with greater stock market turnover are more likely to have diminished insiders ownership and more likely to become widely held. Second, firms with high book-to-market

ratios are less likely to become widely held. Third, the firm's recent stock market performance will significantly increase the likelihood for the insiders to reduce their ownership. Moreover, insiders in the U.S. firms sell shares in substantial amounts and insider ownership fall steadily following an initial public offering (IPO). Helwege *et al* find that, 10 years after IPO, half of the sample firms in their study have less than 20% insider ownership.

Helwege *et al*'s findings are in line with a previous study by Denis and Sarin (1999), who conduct a time-series study to examine listed firms over a 10-year period from 1983 to 1992 in the U.S. Denis and Sarin (1999) find that there is a subset of the sample firms, which experience substantial changes in ownership and board structure in individual firm-years. They also find that such changes are correlated with one another and represent discrete shifts in ownership structure and board composition. They hence conclude that ownership and board structure changes are part of an adjustment process that re-allocates assets to different uses and to different management teams in response to a change in business conditions.

Such phenomenon in U.S. is not found in other countries, particularly in Asia where firms are predominantly owned, controlled, and managed by families. Even after an economic shock in 1997, the firms in Asian countries might experience some changes in the board structure but their ownership remains highly concentrated in the hands of a few families (Claessens, Djankov and Lang, 2000). Claessens *et al*'s findings show that family-owned firms in Asia are able to maintain their concentrated ownership, and are less inclined to convert to diffuse ownership, even in difficult times.

### **3.3.3 Family-owned firms and firm value**

In view of the prevalence of family ownership in the world apart from the U.S., U.K., and Japan, researchers are keen to find out if family-owned firms will out-perform non-family owned firms in terms of their market valuation or accounting measures. This sub-section discusses the advantages of family ownership in contributing to firm value as uncovered by extant research studies. In Section 3.3.4, the effect of an additional variable, corporate governance in family ownership, on firm value will be discussed.

Previous literature has argued both for and against the claim that concentrated family ownership leads to more beneficial economic performance of a firm. Shleifer and Vishny (1997) point out that concentrated ownership gives the owners a strong incentive to

monitor the managers, thus reducing agency costs connected to hired hands in management. Concentrated ownership may also make the task of monitoring the managers easier.

Anderson, Mansi, and Reeb (2003) argue that family ownership is associated with a lower agency cost of debt. In their study of Standard and Poor's (S&P) 500 firms, they find that one third of their sample firms have continued family ownership by the founding families (i.e. the founding ownership) with an average holding of 19% of the firm's shares. Since most founding families have the desire to pass the firm onto the next generations and are concerned with the reputation of the family and the firm, they are more likely than other shareholders to rank firm survival above wealth maximization. Under such circumstances, the divergence of interests between family shareholders and bondholders will be less severe than between diversified, widely dispersed shareholders and bondholders. A lower agency cost of debt follows. Anderson *et al* do find empirical evidence that such is the case: after controlling for the industry and firm effects, they find the cost of debt financing for family firms is approximately 32 basis points *lower* than in non-family firms. Family ownership is therefore regarded by bondholders as a company structure that protects better the bond investor' interests. With a lower cost of debt financing, family owned firms stand in a much more competitive position in their investment environment than do the diffusely owned businesses.

Anderson *et al*'s findings are echoed in the study by Klock, Mansi, and Maxwell (2005), who look into how a firm's corporate governance affects its bondholders. Using a panel data of 678 industrial firms from the U.S. for the years 1990, 1993, 1995, 1998, and 2000, Klock *et al* study 1,877 firm-year observations and find that firms with highest quartile of strong takeover defences are associated with a lower cost of debt financing. Firms in the lowest quartile of takeover defences, on the other hand, are associated with a higher cost of debt financing. Their findings suggest that when families tightly control firms so that takeovers are hardly likely to happen, their costs of debt financing should be lower than those of non-family businesses.

Villalonga and Amit (2006) propose that the study of family ownership's impact on firm value should be decomposed into 3 components: family ownership, family control, and family management. Using samples from Fortune 500 firms in the period 1994 to 2000, they find empirical evidence for the differential effect of family ownership, control, and management on firm value. They find that different forms of family ownership, control, and management make family firms more or less valuable. Family ownership creates value

only when it is combined with certain forms of family control and management. Their result shows that descendant-CEOs destroy firm value whether or not the family has established control-enhancing mechanisms. Their findings shed new light of analysis of family-owned businesses and the firms' valuation.

The research findings quoted above indicate that family-owned firms benefit from lower agency costs and a lower cost of debt that contribute positively to firm value. Family ownership, however, creates value only when it is combined with certain forms of family control and management. While this detailed classification of family ownership by Villalonga and Amit (2006) may yield insightful analysis into the relationship between firm ownership and firm valuation, the present study does not attempt to do likewise for the Hong Kong firms, as most Hong Kong firms are always owned, controlled, and managed by the same family. The chairman, or the CEO, is usually the founder of the firm who has accumulated expertise in the field over a relatively long-term horizon. If the role of the CEO is taken up by another person, the incumbent person usually comes from the same family, and in most cases is selected from the second or third generation of the founder's family. The chairman remains tightly in control of the firm through his/her status as the head of the family.

In the next section, the corporate governance problems relating to a family owned business will be discussed.

#### **3.3.4 Family-owned firms and corporate governance**

Researchers have identified two facets of the core agency problem in listed firms. The first is the principal-agency problem that arises from the separation of ownership and control (Type I agency problems). The second is the agency problem that arises between controlling and non-controlling shareholders, which produces the potential for private benefits of controls to the controlling shareholder but not provided to the non-controlling shareholders (Type II agency problems) (Gilson and Gordon, 2003). Ali, Chen and Radhakrishnan (2007) find family firms in the U.S. face less severe Type I agency problems but more severe Type II agency problems than non-family firms.

In a firm with majority family ownership, there may be yet another corporate governance problem that is quite distinct from the conventional agency problems. Nepotism may take place when executive appointments are made based on favouritism, family relationship, or social networking, but not on capability. The CEO (usually a parent or head of household



of the controlling family) may spread a sense of entitlement among family members, and “uses the firm’s resources to provide family members with employment, perquisites, and privileges that they would not otherwise receive” (Schulze, Lubatkin and Dino, 2003, p. 180).

When firm-level nepotism is commonly accepted and widespread, there is a high likelihood for cronyism to prevail at an economy level. Research findings also suggest that, at a macro-economic level, countries with weak legal systems are particularly vulnerable to a loss of investor confidence if the firms are infested with cronyism-related agency problems. Under a legal regime with a weak minority rights protection, outsiders cannot hope for the courts’ decisions to shield them from majority shareholders’ expropriation, as the court may not rule against any moves by the majority shareholders that have been already stated and allowed by the corporation’s charter. Outside investors would need to rely on themselves, to reassess the likelihood, and the likely extent, of expropriation by the insiders and adjust the amount of capital they are willing to provide. The aggregate result is that when the economy faces a downturn, there will be a fall in asset values in those countries with weak legal protection, and a collapse of the country’s exchange rate, as evidenced in the 1997 Asian financial crisis (Johnson, Boone, Breach, and Friedman, 2000).

In their study of the 1997-1998 Asian financial crisis, Johnson *et al* posit a theoretical model that explains the macro level impact of weak corporate governance. If expropriation by the insiders increases when the expected rate of return on investment falls, then an adverse shock to investor confidence will lead to increased expropriation, lower capital inflow into the country, and greater attempted capital outflow from the macro economy. They present evidence that a weak enforcement of shareholder rights has first-order significance in determining the extent of exchange rate depreciation and the stock market collapse in that period.

If the empirical evidence is pervasive, then the logic should apply at a micro-level to all investors, even if an economic crisis is not looming. Prudent outside investors in the same country may have every reason to reassess the likelihood of expropriation by a firm’s insiders, and adjust the price they are willing to pay for the firm’s shares, controlling for the level of legal protection within the country. In Asia, family firms are notorious for putting the interests of the family above the interests of other stakeholders of the firm

(Wiwattanakantang, 2001). Due to immense voting power and frequent involvement in management, families can often implement policies that benefit themselves but are detrimental to the firms' performance (La Porta, Lopez-de-Silanes, and Shleifer, 1999). As a result, shareholders' interests may suffer. Faced with this information asymmetry and the potential risk of being exploited, the outside investors are expected to seek more disclosure from these firms to assess the risk, to look for assurance from the insiders that a proper CG mechanism is installed to safeguard their investments, and to enhance their protection. Because the insiders of family-owned firms can easily expropriate the minority shareholders without breaking the law, it is natural for outside investors to become more cautious, and prudent, about investing in family-owned firms. In addition to the legal rights that the minority shareholders are entitled, the outside investors also need to find ways to increase the monitoring of the family-owned business in which they have invested.

As discussed in Section 2.4.2 of Chapter 2, the board of directors is generally regarded as the apex of the internal control system, vested with the power to "hire, fire, and compensate the CEO and to provide high-level counsel" (Jensen, 1993, p. 862). However, dominance of the board by family members, and entrenchment of family members in the executives, will undermine the effectiveness of the board in its monitoring of a family-owned firm's management. The presence of independent non-executive directors (INEDs) is therefore a necessary condition to exert effective monitoring of a family firm.

To the outsider investors, the composition of the board in a family-owned firm may indicate how much emphasis a family-owned business would place on addressing its corporate governance issues. The composition of the board means whether there are family members sitting on the board as well as the proportion of the INEDs on the board. In the worst scenario of poor corporate governance, where the independent directors are compromised leading to a failure to perform their fiduciary duties to the fullest extent, the outside investors have a high likelihood of being expropriated. Investors are expected to refrain from subscribing to the firm's shares, or discount the stocks accordingly. Firm value will be suppressed (Claessens and Fan, 2002; Beiner, Drobetz, Schmid, and Zimmerman, 2006).

Conversely, if investors receive adequate information about the corporate governance of the family owned firms, their confidence in the investment will be enhanced. Good corporate governance instils investor confidence (Defond and Hung, 2004), and the

disclosure practices of corporate governance are positively related to firm valuation (Durnev and Kim, 2005). When a family owned firm takes the initiative to make voluntary disclosure of the composition of the board, or when the firm decides to have installed a relatively larger proportion of independent directors than other similar family owned firms, it is providing a signal about its corporate governance. Strong corporate governance has been found to be positively linked with better firm performance for family-owned firms in Asia. Yeh, Lee, and Woidtke (2001) find empirical evidence in support of this argument in their study of 208 listed companies of Taiwan, which is a representative sample that covers 73% of the total listed companies on the Taiwan Stock Exchange in 1993. They find that, within the family-controlled firms, the higher the independent director representation on the board, the higher is the relative firm performance in Tobin's  $q$  and return on assets.

### **3.3.5 Section summary**

This section has discussed the nature of family ownership, the costs and benefits of family ownership, its differences as compared with diffused ownership, and its prevalence outside the U.S., U.K., and Japan. A description of the incidence of family members sitting on the board of directors for family firms (particularly for the Hong Kong firms in this study) is presented. The relationship between family-owned firms and firm value is explored, and the impact of the corporate governance issues on firm value is analysed. In the next section, a discussion will be presented on the leverage of the firm. Prior literature has established that leverage can impact on firm value, and recent researchers suggest that leverage has a corporate governance role to play. As such, leverage is used as a control variable in this study (further discussion will be in Chapter 7).

## **3.4 Leverage of the firm and corporate governance**

This study is concerned with the impact of corporate governance structure and practices on the valuation of a firm. As there are other variables that may have impact upon a firm's value such as its leverage, it is useful to explore the linkage between leverage and firm value, which is discussed in Section 3.4.1 that follows. Section 3.4.2 discusses the relationship between leverage and agency costs and reviews the extant literature on the role of leverage in curbing the agency problems of a firm. Section 3.4.3 summarizes prior studies on the linkage of leverage and ownership structure. Because agency theory (Jensen and Meckling, 1976) predicts agency problems will arise when the ownership and control

of a firm's resources are separate, how to monitor the agents (i.e., the managers) without incurring strenuous costs becomes a pressing issue both to the equity-holders and bond-holders of a firm. Section 3.4.4 explores the relationship between leverage and the external corporate governance mechanisms, and discusses how creditors' rights can be protected at a market level. The section ends with a brief section summary.

### **3.4.1 Leverage and firm value**

Finance literature has established that a firm's capital structure (i.e. leverage) may affect a firm's investment strategies, and hence its value. Myers (1977) demonstrates that excessive debt will induce managers to act in shareholders' interests to forego positive net present value projects, giving rise to the 'under-investment' problem of debt financing which occurs when a firm has risky debt outstanding. The manager will follow a different decision rule than the one in another company who has access to risk-free debt or who has no debt at all. Myers bases his argument on the reasoning that most firms are valued as going concerns. Such going-concern value reflects an expectation of continued future investment by the firm. However, such investment is discretionary, and the investment amount depends upon the net present values of opportunities as they arise in the future. If the future state is unfavourable, the firm declines to invest. In other words, part of the value of a firm is accounted for by the present value of options to make further investments on *favourable* terms. Hence, for firms that have growth opportunities, debt has a negative effect on the value of the firm.

On the other hand, there is a possibility of an 'over-investment' problem. As suggested by Jensen (1986) who argues that, when firms have more internally generated funds than investment opportunities with positive net present value, a firm's debt will force the managers to pay out funds that might otherwise have been invested in negative net present value projects. In this sense, the presence of debt in a firm's capital structure is useful because it mitigates the firm's agency cost and prevents the managers from rewarding themselves by expanding the scale of the firm – even if by doing so it is detrimental to the shareholders. Hence, debt has a positive effect on the value of a firm.

If the under-investment problem and the over-investment problem of debt financing are part of the agency problems arising from the separation of ownership and control of the firm, then an alignment of interests between the owners and the managers may help solve

the problem. Morck, Shleifer, and Vishny (1988) suggest that managerial ownership of equity may have a positive or a negative effect on a firm's value: the Tobin's  $q$  of a firm first rises, then declines, and finally rises as the managerial ownership increases. Morck *et al* use a ratio of long-term debt to a firm's total replacement value of its plant and inventories to control for the possible impact of a firm's leverage on its market valuation. Their empirical test results find a small, negative, relationship between the firm's leverage and  $q$ , although the coefficient is not significant.

McConnell and Servaes (1995) carry out an empirical study to investigate the connection between the roles of equity ownership, debt, and corporate value. In their sample of 1,943 U.S. listed firms for years 1976, 1986, and 1988, they find that firms with few growth opportunities have a Tobin's  $q$  *positively* correlated with the level of debt financing. For firms with high growth opportunities,  $q$  is negatively correlated with the level of debt financing. In other words, a firm's value (as proxied by the Tobin's  $q$ ) can be affected by its leverage but is also mitigated by the growth opportunities the firm is facing.

Myers (1984) proposes a modified pecking order theory for the capital structure of the firm. It is stated that as firms are unwilling to pass by any positive NPV (net present value) projects, or to issue stock at a price they think is too low, they will cover part of their normal investment outlays first with its retained earning, and if insufficient, with new borrowing. Since investment opportunities fluctuate relative to internal cash flow, a firm will from time to time use up its power to issue safe debt. When this occurs, the firm will issue less risky securities first (i.e., debt), then convertible bonds, and finally issuing common stock. A prudent firm will avoid any material costs of financial distress and try to maintain some reserve borrowing power as financial slack so that it can issue safe debt if it needs to. It follows that the average debt ratios will vary from industry to industry, because asset risk, asset type, and the need for external funds also vary with industry. In a similar vein, a long-term industry average of debt ratio will not serve a meaningful target for individual firms in that industry as each firm may be at different stages of development. Hence, Myers concludes that no target debt-equity ratio exists (*ibid*, 1984; 2001).

If no industry-wide target debt ratio exists even for firms that belong to the same industry, then the analysis of a firm's valuation should take the individual firm's contemporary state of debt into consideration. Each firm's value depends on its future profitability and potential risks. As the financial leverage risk is firm specific rather than conforming to an

industry norm, it is necessary to control for this firm-specific variable in the specification of the model explaining the relationship between corporate governance and firm value. In this study, the firm's leverage is considered as a control variable.

### **3.4.2 Leverage and agency costs**

Conventional corporate finance literature has established that a firm's leverage has an impact on firm value. Extant finance researchers add to leverage's function that debt helps to monitor agency costs (Grossman and Hart, 1982). Jensen (1986) proposes a free cash flow theory, which hypothesizes that when cash flow is high in a firm, the managers tend to invest in negative net present value (NPV) projects rather than pay out cash. The managers value investment because their perquisites increase with investment. If there is cash flow left over (i.e., free cash flow) after the firm has exhausted its positive NPV projects, it creates incentives for managers to over-invest. Jensen (1986) states that the proportion of debt in a firm's capital structure helps to keep at bay the manager's self-serving interests in empire building. Leverage has a role to play in mitigating a firm's agency costs. In the extreme scenario of a firm's bankruptcy (i.e., a firm being unable to repay its debts), managers will lose the benefits of control or suffer from a loss of reputation. Debt can therefore create an incentive for managers to work harder, consume fewer perquisites, and make better investment decisions in order to reduce the probability of bankruptcy. In a similar vein, Stulz (1990) suggests that a firm's leverage mitigates agency problems between outside shareholders and insiders.

Such disciplinary function of debt is challenged by Zwiebel (1996), who points out that very often managers make financial decisions on a firm's leverage at the *beginning* of each financial period. A 'good' project with positive net present value often becomes known later. It means that managers make investment decisions *after* the firm's leverage state is relatively determined. Managers commonly undertake capital structure decisions without any apparent extraordinary external threat; and they appear to be capable of reversing previous financing decisions. Under such circumstances, the argument by Grossman and Hart (1982) that the potential threat of bankruptcy has a disciplinary effect on manager's self-serving behaviour and has a function of monitoring agency cost is sound only *ex post*, not *ex ante*. Zweibel (1996) proposes a dynamic model of leverage such that managers voluntarily choose a debt ratio that responds simultaneously to the threat of a takeover (due

to bankruptcy) and to the ambition of expanding their empire (also to be discussed in Section 3.4.4).

Zweibel's dynamic model is based on the premise that managers derive utility both from retaining control and from undertaking new projects (*ibid*, 1996, p.1199), be the projects good or bad. As a counter-argument, Zweibel puts forward an extreme scenario in that if bankruptcy is imminent regardless of what investments are undertaken, a manager will never refrain from bad projects. His model assumes that the market for corporate control is always in action, the availability of a good project is independent across periods of time, and such a good project becomes known after the capital structure decisions are made (often at the beginning of each financial period). Some of these assumptions are tenable. Managers voluntarily choose the level of debt, knowing full well that there is a risk of bankruptcy if the debt financing is used improperly. The agency costs to the managers, therefore, are the likelihood of managerial replacement when a bankruptcy or takeover subsequently occurs, should a bad project be undertaken. Debt, as argued by Zweibel, links up the future retention of managers with the current as well as the anticipated future investments.

Zweibel's dynamic model is not yet empirically tested to the full. Jiraporn and Gleason (2007) examine the strength of shareholder rights and the financial leverage of 4,638 firms across 5 years (1993, 1995, 1998, 2000, and 2002) and they observe a negative relation: firms where shareholder rights are weak carry more debt. They interpret their findings as consistent with agency theory, which predicts that firms with weak shareholder rights (i.e., higher scores in their governance index signifying more restrictive anti-takeover mechanisms) incur higher agency costs and thus carry more debt. In their conclusion, debt is used as a means to contain agency costs in firms where shareholder rights are restricted.

In this study, a firm's leverage is treated as a control variable in the analysis of a firm's corporate governance and its market value. Leverage has a function in monitoring agency costs. The level of a firm's leverage may indicate the extent or seriousness of agency costs prevalent in a firm, even though it may have been determined *ex ante* as stated by Zweibel (1996). Furthermore, when the managers themselves are predominant owners of the firm (such as the case of firms in Hong Kong), the potential threat of losing managerial entrenchment seems low even if bad investment projects are undertaken. In the presence of a predominant shareholder, the motivation does not seem strong for the managers to choose voluntarily a level of leverage as a means to commit themselves to forgo bad

investments so as to prevent a potential takeover. Nevertheless, leverage and agency costs are both influenced by the decisions of the managers, who are also subject to the monitoring by the board of directors, investor beliefs about firm quality, as well as the corporate governance mechanisms available to the external fund-suppliers.

As the board of directors represents the interests of owners of the firm in monitoring the manager's actions, the ownership of the firm may have an impact on a firm's decisions on leverage. Section 3.4.3 below explores the relationship between leverage and ownership, in particular the case of concentrated ownership. Section 3.4.4 is to discuss the relationship between leverage and corporate governance mechanisms.

### **3.4.3 Leverage and ownership**

Harris and Raviv (1991) point out that a firm's debt financing can tackle two types of conflicts identified in the agency theory of Jensen and Meckling (1976), namely, the conflicts between shareholders and managers, and the conflicts between debt-holders and equity-holders. In tackling the conflicts between shareholders and managers, the use of debt can commit the managers to pay out cash, reduces the amount of surplus cash available to managers to engage in empire building, prevents excessive perquisites consumption, and ameliorates managers' probabilities in identifying value-increasing projects.

In tackling the conflicts between debt-holders and equity-holders, the presence of debt can restrict the 'asset substitution effect' whereby equity-holders become reckless and invest in very risky projects, hoping that the potential loss in value of the equity from poor investment can be more than offset by the gain in equity value captured at the expense of debt-holders. Bond contracts, therefore, are expected to include features or covenants that attempt to prevent asset substitution by requiring some interest coverage, or prohibiting the firm from investing in new, unrelated lines of business.

Harris and Raviv (1991) find that debt levels are higher in those industries in which opportunities for asset substitution are more limited, *ceteris paribus* (*ibid*, 1991, p. 301). The same argument can be extended to individual firms: for firms with limited opportunities for asset substitution, debt levels are higher, *ceteris paribus*. Furthermore, a more transparent style of management can limit opportunities for asset substitution. Hence,



more voluntary disclosure of a firm's corporate governance may drive a higher level of leverage. For firms with a predominant family owner, they have a longer-term reputation to protect. They tend to be under-diversified in their portfolios and have less incentive for further asset substitution (see Anderson, Mansi, and Reeb, 2003; Klock, Mansi, and Maxwell, 2005 as discussed in Section 3.3.3). Consequently, leverage tends to be higher for family businesses than for firms that are diversely owned, *ceteris paribus*.

With the prevalence of concentrated ownership in families (such as firms in Hong Kong), external debt-holders have yet another concern: how well will the debt-holders be protected in case of a default by the firm? Will the court uphold the rights of debt-holders prior to the rights of equity-holders? What stance will the institutional framework take towards bankruptcy? Are there any governmental policies that would prohibit the market for corporate control from functioning? The strengths of external corporate governance (as discussed in Chapter 2) will come into play in determining a firm's level of leverage. Section 3.4.4 below discusses the possible impact of the external corporate governance on a firm's leverage.

#### **3.4.4 Leverage and external corporate governance**

External mechanisms of corporate governance generally refer to the legal system, the management labour market, and the takeover markets (Shleifer and Vishny, 1997; Denis and McConnell, 2003; Boubakri, Cosset and Guedhami, 2005). This section discusses the relationship between leverage and external corporate governance mechanisms in the prior literature. The detailed provisions of legal protection mechanisms will be presented in Chapter 4 below.

Pressure from the takeover market may force firms to increase leverage. As has been discussed in Section 3.4.2, Zwiebel's (1996) dynamic capital structure model posits that managers may take on debt so as to commit to paying out future cashflows. By doing so, the managers may make the firm unattractive to raiders and reduce the threat from the hostile bidders. His theory has so far not been empirically tested.

For firms operating under weak legal protection of investors, Himmelberg, Hubbard, and Love (2002) hypothesize that weak investor protection may be the cause for the insiders to hold a higher proportion of the firm's equity. Due to the conflicts between insiders and outsiders and the reluctance of the outsiders to finance the firms under poor legal

protection, the insiders may retain a larger equity share than they would in a perfect risk diversification strategy. Himmelberg *et al* predict that such a higher share of insider ownership, and the resulting exposure of insiders to higher idiosyncratic risk, will lead to under-investment and higher cost of capital for a firm in a weak investor protection environment. They document a negative relationship between the degree of investor protection and the fraction of equity held by insiders for firms in 38 countries.

An implication of the results of Himmelberg *et al*'s (2002) study is that when weak investor protection goes hand in hand with high insiders' equity share, success of takeover by raiders should become difficult to come by. With greater equity shares, the insiders will have more voting power to fence off a hostile takeover bid for fear of the loss of their entrenchment, even though the bidder's offer can be beneficial to all the shareholders eventually. Furthermore, in a weak equity investor protection regime, the debt-holders are treated more favourably than the equity-holders hence a higher leverage level of firms is expected.

Legal protection of shareholders and creditors varies with country. In countries with strong statutory legal rights such as the U.S., shareholders are protected by law to exercise their rights to vote on important corporate matters such as the mergers and liquidations. These include the right to appoint auditors and to vote directors into the board of directors (Shleifer and Vishney, 1997). In countries with weaker legal systems, shareholder-voting rights are violated more flagrantly (e.g., Russia). Managers may threaten to layoff those employees who are also shareholders unless these shareholders agree to vote with the management. They may deliberate in notifying shareholders about the annual meetings, or try to prevent non-concomitant shareholders from voting based on technicalities (*ibid*, 1997, p. 751).

In terms of creditors' rights, the variation may even be bigger across countries. Some countries offer stronger creditor rights than other countries, such as the right to grab assets that serve as collaterals for the loans, the right to liquidate the company when the company fails to repay its debts, the right to vote in the decision to re-organize the company, and the right to remove managers in re-organization. Restrictive measures can also be built into the covenants to prohibit the borrowing firms from investing in negative present value projects, or forcing the firm to sell asserts that are worth more in alternative use.

In sum, Shleifer and Vishny (1997) point out that creditors are likely to be afforded more effective legal protection than equity holders. The crucial feature of the creditors' legal rights is that concerted action by multiple creditors is not required against a delinquent debtor. If any of the creditors is not repaid, the individual creditor has the right to investigate the accounts of the firm, and grab its collaterals. Failure to repay triggers the transfer of control over the assets from the borrower to the lender without the need of a class action, as is usually the case of diverse outside equity-holders.

To conclude, the above-mentioned discussion suggests that the leverage of a firm is influenced by the external corporate governance mechanisms, such as the likelihood of takeovers and the statutory rights granted to the creditors. External corporate governance mechanisms can provide effective monitoring of a firm's management. Very often, by enforcing investors' rights, these external corporate governance mechanisms may substitute for a firm's internal corporate governance mechanisms. However, the degree of legal protection of debt-holders and equity-holders varies across countries; as exemplified by the varied incidents such as takeovers and acquisitions for corporate control, court cases on commercial disputes, class actions by stakeholders, and the judicial reviews on investor protection regulations in different markets. Unlike a cross-country study, this thesis is a within-country study of listed firms in Hong Kong and the external corporate governance factors are not the focus of this research. They are presumed to exert the same influence on all sample firms without exception as all firms in this study are domiciled in Hong Kong and are operating in the same legal protection environment. This study analyses the sample firms' market value and their voluntary disclosure of internal corporate governance mechanisms and practices but controls for their leverage.

### 3.5 Summary

This chapter discusses a firm's ownership structure, its leverage, and how they may affect the firm's corporate governance mechanisms and practices. Empirical studies have shown that, in many markets, ownership of modern days' corporations is not necessarily dispersed as perceived by Berle and Means (1932). Firms with concentrated ownership are not uncommon. A special type of concentrated ownership, namely, family ownership, is highlighted for discussion. The agency problems as posited by Jensen and Meckling (1976), which are derived from dispersed ownership and from the separation of ownership and

control, may not be applicable to firms with concentrated ownership. Entrenched managers and the expropriation of minority shareholders are the more pressing issues of concern for the investors instead. In the case of family ownership, appointment of family members to the board of directors or to key managerial positions appears to weaken minority shareholder's monitoring efforts of the insiders.

The relationship between ownership structure and firm performance is also discussed in this chapter. Prior literature on this relationship has been reviewed. The findings of the previous empirical studies are ambiguous as to whether a linear relationship exists between the level of insider ownership and the performance of a firm. Research studies in recent years seem to suggest that the relationship between insider ownership and firm performance is subject to the influence of some mitigating factors such as the presence of a dominant family owners and the duality of chairman and CEO (e.g., Chen, Cheung, Stouraitis, and Wong, 2005; Haniffa and Hudaib, 2006). A section has also been dedicated to discussing family-ownership, as firms owned and controlled by families seem to give rise to different types of agency problems from those firms with diffuse ownership.

This chapter has also reviewed prior studies on the relationship between ownership structure and dividend payout of a firm. It summarizes the findings of the salient empirical studies which give evidence to support LLSV's (2000b) claim that dividends have a corporate governance role to play, although each of LLSV's (2000b) two agency models of dividends has received its own backing. The empirical evidence so far seems to suggest that both dividend models are feasible, subject to the joint influence by external corporate governance mechanisms and the ownership structure of the firm.

This thesis aims at contributing to this literature by analysing the impact of voluntary disclosure of corporate governance mechanisms and practices (which include, among others, the separation of roles of chairman and CEO) on firm value, controlling for some firm-specific characteristics such as insider ownership and leverage (to be further discussed in Chapter 7). It also explores the relationship between the voluntary disclosure of corporate governance and dividend payouts of firms so as to test whether voluntary disclosure can help reduce the information asymmetry between the insiders and the outsiders, thus be used as a substitute for a monitoring device of the insiders, under a strong legal investor protection regime.

The next chapter, Chapter 4, presents a discussion on extant studies on legal protection of minority shareholders and how it relates to a firm's corporate governance. Particular attention will be drawn to how the legal system can reinforce investors' confidence in a capital market. In an open economy such as Hong Kong where a strong legal protection for minority shareholders exists in the presence of concentrated family ownership, the outsiders may need to resort to additional measures of corporate governance to protect their rights and enhance their confidence. These measures such as voluntary corporate governance disclosure, cross-listing, and analyst following of a firm, will be discussed in Chapter 4. The motivations for voluntary disclosure and how it affects a firm's valuation will also be explained. Finally, the argument that a firm's very act of disclosing voluntarily its corporate governance can affect a firm's valuation will be introduced.

# Chapter 4: Relationship between Legal Protection, Corporate Governance, and Voluntary Disclosure

## 4.1 Introduction

This thesis aims to analyse the relationship between the voluntary corporate governance (CG) disclosure of a firm and its valuation from a shareholder's perspective. In this study, any disclosure by the firm in addition to the mandatory requirements as stated by the market regulatory institutions is referred to as voluntary disclosure. Disclosure by a firm is often governed by the legal environment in which the firm operates. The legal framework determines the type and the level of mandatory disclosure by a firm in the annual reports. In theory, when a firm fully complies with all the legal disclosure requirements, it has fulfilled its communication obligations to its investors and regulatory institutions. There is no need for voluntary disclosure. Yet, in practice, many firms are observed to voluntarily disclose in their reports more information than what is statutorily required by the legal framework of their business environments (Lang and Lundholm, 1993).

This chapter examines the impact of legal protection of minority shareholders on corporate governance (CG). Section 4.2 reviews the literature on how legal protection of investors is related to the CG framework of a country. It discusses the significance of a strong legal protection regime to the growth and development of a financial market and its usefulness in reinforcing investors' confidence in that market. The effect of culture on investor protection is also discussed. Section 4.2 will also suggest some indicators of the CG of a firm (e.g., dual listing and analysts' following) for minority shareholders to ascertain their protection under a concentrated family ownership and in a strong legal protection environment such as Hong Kong. Section 4.3 reviews the literature on the motivations for a firm to voluntarily disclose non-financial information and presents the measurement of voluntary disclosure. The argument that a firm's very act of disclosing voluntarily its CG information can affect a firm's valuation will be discussed. In addition to the legal environment, there are other firm-specific characteristics variables that may affect a firm's internal CG structure. They are discussed in Section 4.4. Section 4.5 summarizes the discussion in this chapter.

## 4.2 Legal protection and the corporate governance framework

### 4.2.1 Literature review of studies of legal protection and corporate governance

The legal strand of corporate governance studies argues that the legal framework of an economy determines the level of legal protection that is available to the investors. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, 1998) posit that the legal system is a mechanism which is fundamentally important to the governance of firms in an economy. The law and its enforcement in an economy determine the rights of the shareholders, and how well their rights are protected. Yet, these legal rights of shareholders differ from country to country, and are dependent upon each country's jurisdiction and its general legal framework. As argued by LLSV, weak laws and weak protection of investors have cost implications for an economy in that "firms probably face difficulty raising equity finance, since minority investors fear expropriation by managers and concentrated owners" (LLSV, 1998, p.1151).

Studies by legal researchers support the importance of legal protection to the development of capital market (LLSV, 1997, 2000a; Rajan and Zingales, 1998; Roe, 2002; Stulz and Williamson, 2003; Claessens, 2006). In an imaginary nation whose law poorly protects minority stockholders from a stock issuer who wishes to extract value from small minority stockholders, a potential buyer fears that the majority shareholder would later channel value away from the buyer. The fear becomes so great that the prospective minority stockholder does not pay the *pro rata* value for the stock. Only when the share price comes with a deep discount will the prospective buyer be tempted. On the other hand, if the discount is deep, the majority stockholder may not be willing to sell. When such impasse continues, concentrated ownership will persist, and stock markets do not develop (Roe, 2002, p. 238). Roe claims that the critical pre-condition to developing modern stock markets is "a foundation of solid corporate and securities laws that protect stockholders from over-reaching dominant majority stockholders or controlling managers" (*ibid*, 2002, p. 233). Without such protection, securities markets will not arise.

The legal approach to corporate governance (CG) put forward by Roe (2002) and LLSV (1998, 2000a) suggests that legal protection of investors from overreaching dominant majority stockholders is critical to the development of securities markets. They advocate

strongly that the legal environment of a country has a significant impact on ownership structure, CG, and firm performance. Roe (2002) suggests that, to induce separation of ownership from control of a firm, it takes more than a high-quality corporate law such as strong fiduciary duties, strong doctrines against self-dealings, and a capable judiciary/enforcement institution. LLSV argue that variations in legal protection and law enforcement at country-level will lead to variations in the firms' ownership structure, availability and cost of external finance, dividend payout, and market valuation of firms (*ibid*, 1997, 1998, 2000a). The legal approach to CG states that the key mechanism is the protection of outside investors – shareholders and debt-holders alike – through the legal system, which consists of both the laws and their enforcement.

Subsequent empirical studies have supported their views by showing that much of the cross-country ownership differences and CG variations of firms are due to the differences in legal protection of minority shareholders (LLSV, 1997, 2000a, 2002). LLSV (2000a) argue that investor protection is crucial in view of the extensive expropriation of minority shareholders and creditors by the insiders (i.e., the managers and the controlling shareholders) found in many countries. Different countries have different origins of law. As a result, different legal systems evolve which give rise to variations in the ability of a country to uphold investor's rights in five main aspects. Derived from the residual control rights framework by Grossman and Hart (1988), these rights are based on investors' equity holding of a firm. They refer to the shareholders' ability to exercise their CG power to (i) change directors; (ii) force dividend payments; (iii) stop a project that benefits insiders at the outsiders' expense; (iv) sue directors and get compensation; and (v) to liquidate the firm and receive the residual proceeds (LLSV, 2000a, p.5). When these investor rights are extensive and well enforced by regulators or courts in a market, investors are willing to finance firms in that market. In contrast, when the legal system fails to protect outside investors, "corporate governance and external finance do not work well" (*ibid*, 2000a, p. 5).

LLSV (2000a) classify the global legal systems into four main categories according to their legal origins: (i) the English common law system; (ii) the French civil law system; (iii) the German civil law system; and (iv) the Scandinavian law system. By examining the summary measures of an anti-director rights index (ranging from 0 to 6) and a creditor rights index (ranging from 0 to 4) of 49 countries, LLSV posit that stronger investor protection regimes offered by the English common law system are associated with more effective corporate governance. LLSV conclude that "the nature of investor protection is



deeply rooted in the legal structure of each country and in the origin of its laws” (*ibid*, 2000a, p. 24). Their findings are supported by other researchers (Johnson, La Porta, Lopez-de-Silanes, and Shleifer 2000; Coffee, 1999a).

Johnson, La Porta, Lopez-de-Silanes, and Shleifer (2000) study well-known court cases of expropriation of minority shareholders by the controlling shareholder in Western European countries (France, Italy, Belgium, and Germany) to identify differences in the courts’ approach to tunnelling<sup>1</sup> in civil law countries and common law countries. They find that European civil-law courts and common-law courts approach cases of tunnelling differently. It is common for the courts to use two broad principles to assess insiders’ business conduct, namely, the duty of care, and the duty of loyalty (i.e., fiduciary duty) (Lorsch and MacIver, 1989). The duty of care means that directors should gather necessary information before making decisions. The duty of loyalty means that directors should be careful to act appropriately when there are conflicts of interests (Smith, 2003, p.87). Johnson *et al* (2000) find that civil law courts emphasize on the predictability of the law and rely on statutory rules to govern any self-dealing behaviour (as a form of tunnelling) of the majority shareholders. The courts often see the expropriation of minority shareholders by the controlling shareholder in a business transaction as consistent with directors’ duties. Any suspicious self-dealing transactions are assessed in light of their conformity with statutes, not on the basis of their fairness to minorities. Generally speaking, Johnson *et al* conclude that courts in civil law countries are found to be more accommodating than courts in common law countries with respect to tunnelling behaviour, although, in most countries, laws prohibit certain kinds of tunnelling.

In contrast, according to Johnson *et al* (2000), common law courts emphasize the notion of fairness to minority shareholders as a broad principle that goes beyond statutes. Common law judges tend to adopt a lesser standard of proof in conflict-of-interest situations and be more willing to uphold the principle of duty of loyalty to the minority shareholders. They often show receptive hearing to those minority shareholders who challenge the transactions of subsidiaries within the same business group on grounds of fairness. Johnson *et al* conclude that civil law countries are less protective of minority shareholders than are common law countries.

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<sup>1</sup> Johnson *et al* define ‘tunnelling’ as the expropriation of minority shareholders, the transfer of assets and profits out of firms for the benefit of those who control them (*ibid*, 2000, p. 22).

Coffee (1999a) documents evidence using data from Polish and Czech firms that both the *incentives* to assert legal remedies and the *availability* of legal remedies had contributed to the systematic looting of companies by their controlling shareholders. He observes that minority shareholders are given greater protection from fraud and expropriation under common law systems (i.e., Poland) than civil law systems (i.e., the Czech Republic). He attributes such difference in investor protection to the notion that “civil law regimes leave public shareholders in a system of dispersed ownership exposed to a “winner-take-all” scramble for control, in which the losers can expect future expropriation by the winner” (*ibid*, 1999, p.38). Nevertheless, Coffee does not consider the laws within the common law regime countries (e.g., the U.S. and the U.K.) as homogenous. Coffee acknowledges that, on closer examination, there are as much the similarities in judicial style and legal enforcement that may separate the U.S. and the U.K. as unite them legally.

Beck, Demirguc-Kunt and Levine (2003a) find a robust link between legal origin and stock market development in their study of 73 former colonies. French Civil Law countries are found to have significantly lower levels of stock market development than British Common Law countries after controlling for other country characteristics such as religious composition, degree of ethnic fractionalization, legislative competition, and years of independence, among other variables. In another study using data collected from 54 countries spanning over French civil, German civil, Scandinavian civil and British common law origins, Beck, Demirguc-Kunt and Levine (2003b) explain that an economy’s legal origin matters in financial development. While the judges in civil law countries simply *apply* the law, the judges in common law countries *interpret* the law. The civil law judges emphasize on exerting rigid state control whereas the common law judges are granted substantial discretion in their jurisprudence. Thus, different legal origins nourish different legal traditions, resulting in a difference in their ability to adjust efficiently to ever-changing socio-economic conditions.

Beck *et al* (2003b) also explain that an economy’s financial development is affected by a difference in legal origin via two channels, namely, the *political* channel and the *adaptability* channel. The political channel contends that legal traditions differ in the priority they attach to private property rights against the state rights. While the English common law evolved to protect private property owners against the crown, the French and German civil codes in the 19<sup>th</sup> Century were constructed to solidify state power by placing the prince above the law. Different degrees of state dominance of the judiciary gradually

result. The adaptability channel is one in which the judges are empowered with substantial discretion to respond to unforeseen and changing conditions case-by-case. By adapting to new circumstances, inefficient laws are challenged in the courts. Through repeated litigation, outdated and inefficient laws are replaced by efficient rules. As the common law legal traditions adapt efficiently over time, the gap between the needs of contracting parties of the economy is minimized. Common law system therefore emerges a system that conduces to the development of a financial market more effectively than other rigid legal systems.

To conclude, this section reviews the literature on the relationship between legal environment and investor protection. Recent researchers, mainly financial economists, have found systematic differences among nations in investor protection, investor voting rights, and ownership structure. These differences seem to correlate closely with the strength of the legal protections given to minority investors (Coffee, 1999a, p. 2). As pointed out by Coffee, the strength of legal protection varies systematically with the nature and origins of each nation's legal system. Common law legal systems seem to outperform civil law legal systems in terms of promoting ownership dispersion and capital market growth (*ibid*, 1999a). Hong Kong is an economy that practices common law. It has been recognised by researchers for its high level of investor protection compared with other East Asian countries. Yet, there is high concentration of ownership as well. This study will use Hong Kong firms as samples to study the relationship between a firm's voluntary CG disclosure and firm's valuation. The relationship is tested on firms subject to a CG framework supervised by common laws with a strong legal investor protection legal orientation. The next section, Section 4.2.2, will examine how the CG framework of an economy at large impacts on the development and growth of a capital market and its financial institutions. Understanding this linkage will help appreciate how the policy-makers of an open economy (e.g., Hong Kong) prescribe the boundary of the legal CG framework for investor protection, and set the mandatory disclosure level for the firms to attain.

#### **4.2.2 Importance of corporate governance to the growth and development of a capital market**

According to a study by Claessens (2006), both institutions (i.e., banks, financial intermediaries, and courts) and rules (i.e., laws, regulations, and standards) matter in the evolution of a country's corporate governance framework. In his opinion, institutions do

not arise in a vacuum, but are affected by the rules in the country or the world. On the other hand, laws and rules are affected by a country's institutional set-up. Thus, both institutions and rules are endogenous to other factors and conditions in the country (such as the ownership structures, the role of the state in passing the legislations through the political economy process, etc.). He identifies five channels through which corporate governance affects a country's financial growth and development (*ibid*, 2006, p. 99):

- (i) increased access to external financing by firms, which can lead to greater investment, higher growth, and more employment creation;
- (ii) lower cost of capital and associated higher firm valuation, which makes more investments attractive to investors and leads to growth and employment;
- (iii) better operational performance, through better allocation of resources and better management, which creates wealth;
- (iv) reduced risk of financial crises, a particularly important effect, as financial crises can impose large economic and social costs; and
- (v) better relationships with all stakeholders, which helps improve social and labour relationships and areas such as environmental protection.

In order to bring about the above-mentioned effects, the rules and regulations environment of an economy needs to provide adequate protection to outside investors at a macro-level. At firm-level, individual firms also need to implement adequate internal corporate governance mechanisms and communicate the quality of governance to the outside investors. In other words, not only do firms need to implement governance provisions, but they also have the incentive to communicate their state of governance (e.g., shareholders' voting rights, creditors' re-organization and liquidation rights) to the outside investors, to signal to outsiders that they are providing additional protection to what is being stipulated by the legal regime.

On the other hand, potential outside investors are to a large extent willing to finance a firm only because their rights are protected by the law. This is so because, unlike the employees or the suppliers of the firm who remain continually useful and are thus placed at a lesser risky level of being mistreated by the insiders, the outside investors are more vulnerable to expropriation. Thus, the need to signal to the outsiders is especially important when firms are operating within a weak legal protection system where company laws, bankruptcy laws, takeover laws, and securities laws provide inadequate protection to outside investors/creditors. When the legal system does not protect outside investors, corporate governance and external finance simply would not work well (LLSV, 2000a, p. 5).

Indeed, weak legal protection of outside investors will lead to a higher cost of equity for the firms. Using variables related to three dimensions of capital market governance – earning opacity, enforcement of insider trading laws, and short-selling – of 33 countries from 1969 to 1998, Daouk, Lee and Ng (2006) construct a capital market governance (CMG) index and examine the association between changes in that index and changes in (i) the cost of capital; (ii) market liquidity (i.e., trading volume and market depth of the stock market); and (iii) pricing efficiency (i.e., IPO under-pricing). They document empirical evidence that, after controlling for other influences, an *increase* in the CMG index is linked to a *decrease* in the cost of equity, an *increase* in market liquidity, and an *increase* in pricing efficiency. Specifically, improved security laws are associated with decreased cost of capital, higher trading volume, greater market depth, increased U.S. ownership, and reduced IPO under-pricing. Improved market-wide corporate governance does bring desirable benefits to individual firms.

Daouk *et al's* findings are consistent with the general view that investors associate bad capital market governance with increased risk: if investors are suspicious of a market's governance, they will be prompted to reduce their trading activity and demand greater premiums for holding equity stock. Indeed, the implications of their findings can also apply to individual stock within an economy: when investors have heightened concerns over a firm's corporate governance, they will be expected to refrain from buying the firm's stock, or demand greater discounts in the stock price before they are prompted to invest in such a corporation. The share price of the firm will be adversely affected. Similarly, even if the investors have agreed to finance a firm with dubious corporate governance, they will be expected to look for higher dividend payouts from the firm to compensate for their increased risk. This thesis specifically tests for these expectations, using Hong Kong firms as samples and controlling for the firm-specific characteristics such as profitability, leverage, and sales growth.

Whilst a cross-country study yields insight into which and why legal system provides stronger legal protection to investors, a cross-sectional, *within-country* analysis can be more pertinent than *cross-country* analyses in lessening the spurious effect of legal system on corporate governance structure and practices. Firms operating within the same country face the same legal protection and institutional constraints, or lack thereof. Conducting analysis at firm level substantially increases the power of the tests and permits the

researcher to compare the strength of the relation across firms in the same country, which controls for many economic, legal, and political variables (Lang, Lins, and Miller 2004, p. 593). In addition, a country-specific analysis avoids endogeneity problems between ownership structure and institutional environments (Joh, 2003, p. 289) whereas cross-country analyses may under-estimate the importance of country-specific laws and regulations. This thesis adopts a within-country approach (i.e., within Hong Kong) to examine the firm's performance of firms (measured by Tobin's  $q$  as in many extant studies) operating with the same legal institutions, external corporate governance environments, macro-economic development stages, accounting standards, and to a large extent, similar ownership structure not only across firms but also across the years for individual firms. Chapter 5 of this thesis will summarize the overall state of corporate governance framework of Hong Kong vis-à-vis other East Asian countries, as described in extant studies by current corporate governance researchers. Meanwhile, the following section will discuss culture, which some researchers consider as important in determining the level of voluntary disclosure by firms.

#### **4.2.3 The effect of culture on disclosure and investor protection**

Stulz and Williamson (2003) argue that a country's culture should not be overlooked when one attempts to explain the differences in investor protection that occur across countries. Culture, according to Stulz and Williamson, is defined as "transmission from one generation to the next, via teaching and imitation, of knowledge, values, and other factors that influence behaviour" (*ibid*, 2003, p.314). In their study, they use religion and language as proxies for a country's culture. Furthermore, they use a country's openness to international trade as a third explanatory variable to account for the differences in investor protection. Their empirical findings based on data on 49 countries suggest that the culture proxies generally have more explanatory power for how a country enforces investor rights than does the country's legal origin. While language is irrelevant except for accounting standards, religion is correlated with law enforcement. Moreover, openness is positively correlated with creditor rights and with the enforcement of rights, but is negatively correlated with shareholder rights. Stulz and Williamson (2003) conclude that they find support for the view that culture does matter in investor protection, but there is also evidence that the impact of culture is tempered by openness.

This thesis uses Hong Kong firms as samples to explore the relationship between the voluntary disclosure of CG mechanisms and practices and the firm valuation. Hong Kong has most of the population (95%) being Chinese. Prior research shows that the disclosure orientation of firms owned by Chinese families in Asia does not encourage voluntary disclosure of corporate information due to high levels of collectivism and power distance, thus exhibit high tendency of adherence to rules but weak inclinations to voluntary disclose (Chau and Gray, 2002; Ball, Robin and Wu, 2000; Chow, Chau and Gray, 1995; Gray, 1988). Stulz and Williamson's study (2003) states that culture has more explanatory power on investor protection of an economy than its legal origin. If their statement is valid, Hong Kong offers an all the more interesting and meaningful arena to investigate investor protection and corporate governance framework in view of the co-existence of a non-disclosure culture of Chinese businessmen and a strong investor protection regime that encourages a high level of disclosure by firms. Moreover, the sample firms in this study are selected based on the criteria that they are either domiciled in Hong Kong, or with their major market being Hong Kong so that the laws of Hong Kong apply in case of any legal disputes. Further discussion of the corporate governance framework of Hong Kong will be presented in Chapter 5, while the next section, Section 4.2.4, is to discuss other measures not related to the legal framework but may enhance investors protection, some of which are being used in the empirical models in this study.

#### **4.2.4 Other non-legal measures that may enhance outside investors protection**

Though legislation and legal enforcement are generally considered as the most effective mechanism to protect minority investors (see discussion in section 4.2.1 above), outsiders still face an information asymmetry problem about the quality of internal corporate governance mechanisms installed, implemented, and maintained by the insiders. Being not as much informed as the insiders, the outsiders of a firm are concerned about whether their interests are adequately protected. They would like to be assured that the insiders (i.e., the managers) would not abuse their investments in a firm. In the presence of a predominant and concentrated family/management ownership, the outsiders' desire for additional assurance of fair treatment by the majority shareholders is even stronger, as the predominant shareholder has enough votes to pass any resolutions in his/her favour on the board meetings and the annual general meetings. With a predominant shareholding present, the conventional external mechanisms such as rule of law and the market for corporate

control may not be sufficient in providing adequate or effective protection to the minority shareholders.

Nonetheless, in addition to the external corporate governance, there are other measures that can proxy for the enhanced protection of minority investors from potential expropriation by the controlling shareholders. Previous studies have suggested, among others, four such measures that can help indicate the level of investor protection offered by a firm, namely, analyst following; dividend payout; the extent of voluntary disclosure; and dual listing (or cross listing) of the firm. Each of them will be discussed in the following sub-sections in turn.

*(i) Analyst following*

Lang, Lins, and Miller (2004) argue that analysts serve a monitoring role. Analysts provide relevant information to investors and act as informational intermediaries between the firm and the market. In the course of providing earnings forecasts, target prices, and buy-sell-hold recommendations to their clients, analysts gather information from various sources – both external and internal to the firm – to assess the firm's investment potential and economic viability.

Using data on 2,094 firms across 27 countries, Lang *et al* (2004) find evidence that analysts are less likely to follow firms with poor internal governance, and this effect is more pronounced when external shareholder protection is weak. In contrast, analysts are likely to follow a firm if it demonstrates progress in corporate governance (provided it is communicated to the analysts) because of more protection from exploitation by the predominant shareholders. Lang *et al* therefore argue that corporate governance plays an important role in analysts' willingness to follow firms. They suggest that analysts play a potentially important role in governance because, like securities regulators and auditors, analysts have the ability to enhance transparency of a firm and therefore have the potential to provide an additional layer of oversight of the firm's management. Their argument is consistent with the hypothesis of Jensen and Meckling (1976), who suggest that financial analysts play an additional monitoring role of the firms when agency relationship problems exist.

Lang *et al* (2004) also find empirical evidence that analysts are less likely to follow firms that have potential incentives to withhold or manipulate information, especially when the



family/management group is the largest control rights block-holder. Their evidence is consistent with the hypothesis that controlling shareholders and insiders may wish to withhold or manipulate information to conceal their private benefits of control from outside shareholders.

Lang *et al's* (2004) study also shows that increased analyst following is associated with higher valuations, particularly for firms likely to face governance problems. However, a firm's higher valuation *per se* may lead to more analysts following because supply-side analysts are obliged to recommend their selected firms to their clients based on significant changes in potential market returns. Bhushan (1989a) argues that more analysts will be attracted to follow a firm if the firm has a large firm size (private information about a large firm has more value than a small firm), a disperse ownership (generates more potential share transactions), varied market returns (private information is more valuable with firms with higher return variability), and complexity of business (leading to higher information acquisition costs). Therefore, the relation between analyst following and firm valuation is well noted by researchers, but the direction of the relation is not clear.

Bushman, Piotroski, and Smith (2004) document evidence of a positive correlation between analyst following, disclosure, and investor protection. Based on the Centre for Financial Analysis and Research's (CIFAR) International Accounting and Auditing Trends study of 1,000 industrial firms over 46 countries in 1995 (CIFAR 1995), Bushman *et al* (2004) document empirical evidence suggesting that analysts might be attracted to firms that exhibit some specific attributes (such as cross listing on U.S. markets). They conclude that from the governance perspective, analyst following, ownership structure, and legal protection appear to be complements of each other. They suggest that firms in environments with better legal protection of minority shareholder rights tend to have less concentrated ownership and more analysts following. Hence, it is possible that an indolent analyst may follow the crowd in recommending a firm based on the above-mentioned attributes even if the analyst fails to find any significant improvement in the firm's internal governance standard. Therefore, the number of analyst following is only at best a necessary condition, but not a sufficient condition, to attest to a firm's quality of corporate governance in regards to protection of shareholder rights. It does not necessarily *initiate* a better state of corporate governance on the part of the firm's management, but it may reflect that the state of corporate governance is acceptable to the investors. Because the

causation of analyst following to firm valuation is not clear, this study does not use analyst following as an explanatory variable.

### (ii) Dividend Payout

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, 2000b) argue that in a world of severe agency problems between insiders and outsiders, dividends have a useful role to play in corporate governance. Dividend payout can be regarded by investors as a return of corporate earnings by the insiders. By paying out cash as dividends, the insiders are no longer able to use these corporate earnings for their own benefits. LLSV (2000b, p. 4) describe vividly that dividends, regarded by investors as “a bird in the hand”, are better than retained earnings (i.e., “a bird in the bush”) because retained earnings might never materialize as future dividends (i.e., “can fly away”). Moreover, payment of dividends now compels firms to come to capital markets in the future to raise external funds when investment opportunities arise. LLSV’s view follow Easterbrook’s (1984) arguments that dividends can keep a firm in the capital market by “uncoupling from profits” (Easterbrook, 1984, p.657) and at the same time “keep managers’ noses to the grindstone” (ibid, p.657) by adjusting shareholders’ risks without necessarily jeopardising the risks of the debt-holders’. Through the mechanism of dividend payouts, the outside investors are given an opportunity to exercise some control over the insiders. Dividend payout therefore has a function to deal with agency problem, hence has a role to play in corporate governance.

In most common law regimes such as the U.K. and Hong Kong, shareholders cannot directly demand a specific level of dividends. However, they can let their voice be heard and raise their concern for low dividend payout in the general meetings of the firm if they are dissatisfied with the dividend policy. Furthermore, shareholders can also collectively vote for a representative to sit on the board of directors to address their concern. If they are disappointed about the pro-longed unsatisfactory level of dividend payout, they can take a final step to vote with their feet, i.e., sell off their stakes on the market. The collective action of these disgruntled shareholders will cause the share price of the firm to drop, which will not be in the interest of the managers/predominant shareholder of the firm. As such, dividend payout serves as a powerful measure that can offer enhanced investor protection, albeit indirectly manifested through the potential drop in a firm’s share prices (and hence its market value). This study uses dividend payout as a dependent variable in examining the relationship between a firm’s dividend payout and its voluntary CG

disclosure, controlling for the firm-specific variables such as profitability, leverage, and sales growth.

(iii) Extent of voluntary disclosure

It has been mentioned in Section 4.2.3 of this study that firms in Asia, where the Chinese businessmen dominate, operate within a cultural environment that typically does not encourage voluntary disclosure of information about the firms. The high concentration of business ownership by families and family groups reflects the importance of ‘family’ in traditional Chinese ideology. In a family setting, personal networking (i.e., *guanxi*) built on informal relationships plays a stronger role than formal legal contracting. Internal, off-the-record, communication with other stakeholders within the same family reduces the need for public disclosure (Ball, Robin, and Wu, 2003). With such a pre-condition, minority outside investors stand the most to lose because, unlike the insiders or family members, they may be kept uninformed and may have to rely on public disclosure to reduce their information asymmetry with the firm. If a firm is to signal to the outsiders that it is treating all investors fairly and equitably, it will have incentives to reduce such information asymmetry between the insiders and the outsiders by engaging in more voluntary disclosure than what is stipulated by the laws and regulations. The extent (or comprehensiveness) of the voluntary disclosure is therefore a strong indicator of a firm’s willingness to offer shareholder protection, in particular if the disclosure is about the installation of corporate governance mechanisms before a firm is required by law to do so.

This study uses voluntary disclosure of CG information as a proxy for investor protection. One may argue that the disclosure of CG mechanisms is at best measuring the extent of mechanisms that are put in place, not necessarily implying a better *quality* of the firm’s CG. However, a firm’s determination to install and *voluntarily* disclose its governance mechanisms earlier, and more than anybody else does, can be a valid proxy to the management’s *commitment* to a high standard of the firm’s CG. A high commitment should give rise to devoted actions to achieve the desired outcome; *ceteris paribus*, leading to a better *quality* of CG than that of other firms’ CG with a lower commitment.

In measuring the extent or comprehensiveness of CG disclosure of a firm, this study follows previous researchers in assigning equal weighting to each provision of the CG

mechanism that is installed and disclosed<sup>2</sup> by the firm. Crude as it may appear to be, most equal-weighted measures apply a horizontal summation of the number of provisions/mechanisms that are disclosed by the firm in binary format (i.e., disclosed or not disclosed) to construct a composite index or score (e.g., see Bebchuk, Cohen and Ferrell, 2008; Beiner, Drobetz, Schmid and Zimmermann, 2006; Black, Jang and Kim, 2006; Brown and Caylor, 2006; Cremers and Nair, 2005; Gompers, Ishii and Metrick, 2003). A higher disclosure score thus signifies a higher extent of disclosure. Using an un-weighted score permits an analysis independent of the perceptions of a particular user group, which vary from user to user or with different purposes (Chow and Wong-Boren, 1987). Many information users, such as analysts and minority shareholders, also rely on such a composite index to arrive at their assessment about the *quality* of the corporate governance, although they are aware of the risk of assessing just for form rather than substance (CLSA, CG Watch 2003, p.7). Further discussion of the motivations and limitations of the measurement of voluntary disclosure will be presented in Section 4.3.2.

#### (iv) Dual listing (cross listing)

When a firm elects to cross list its shares on another stock exchange in a foreign country, it subjects itself to both foreign and domestic listing regulations. In return, cross listing may secure additional, and likely, cheap, equity capital for new investment to broaden the shareholders' base. It may also enable controlling shareholders to divest on a liquid market, or prepare for new acquisitions, to enhance firm's reputation (Pagano, Roell, and Zechner 2002). Cross listing comes with additional costs, and the management of a cross-listed firm has to weigh the benefits against the costs of such discretionary action before proceeding to do so. In terms of investor protection, the choice of listing location of a firm has a signalling effect. For example, a firm already listed on an exchange with low domestic regulatory standards that decides to secure listing in a stock market with high regulatory standards shows a commitment to disclosure and governance standards to the current and potential shareholders (Fuerst, 1998). By subjecting itself voluntarily to tighter standards, a firm from countries with poorer legal protection standards shows its determination to reduce agency cost of external finance and hence can often secure a lower cost of capital (Stulz, 1999). Reese and Weisback (2002) also argue that managers of firms that decide to cross-list signal to the market a reduction of their private benefit.

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<sup>2</sup> It may be argued that a firm may have installed some CG mechanisms but may choose not to disclose. It may even be suggested that a firm may disclose some CG mechanisms that it has not installed. Though these possibilities may not be ruled out, in practice the likelihood of such incidents is so low in a scenario where disclosure is *voluntary*, not mandatory, that it is not considered in this study. This study assumes that a firm will disclose voluntarily its CG mechanisms that it has installed, no less and no more.

Hence, cross listing can be construed, and perceived, as an indicator of an enhanced level of corporate governance for a firm. It is used in this study as a control variable in the analyses of the empirical models.

Empirical research studies have shown that firms that trade on more than one stock exchange are likely to have better corporate governance (Klapper and Love, 2004; Pagano, Roell & Zechner, 2002; Karolyi, 1998; Saudagaran, 1988). Klapper and Love argue that, since reporting standards and investor protection in the U.S. are much higher than in most other countries, firms in emerging markets would be required to improve their corporate governance provisions in order to list on the U.S. stock exchanges. This is because listed shares on a U.S. exchange are subject to many Securities Exchange Commission laws and regulations that protect minority shareholders. Their argument finds support from Coffee (1999b), Stulz (1999), and Reese and Weisbach (2002) who share the view that cross listing on another exchange, particularly in the U.S., provides a mechanism by which foreign firms can voluntarily subject themselves to some additional shareholder protection under that foreign jurisdiction. Because cross listing is most likely to be voluntary and almost invariably a costly exercise, by so doing firms signal their higher corporate governance quality to investors through greater disclosure and transparency, more stringent accounting standards, and commitment to comply with more stringent governance standards to protect foreign investors. In return, cross-listed firms tap into cheaper capital, broader shareholder base, and higher firm visibility.<sup>3</sup>

Another argument which supports the claim that cross listing is used as a signalling device for good corporate governance is provided by Lang, Lins and Miller (2003) and Doidge, Karolyi, and Stulz (2004). Lang *et al* argue that firms that cross list in U.S. markets are “bonding” themselves to an increased level of disclosure and scrutiny (*ibid*, 2003, p. 318) because when compared to other countries, the U.S. has a more demanding litigation environment; the Securities and Exchange Commission (SEC) has increased enforcement power; and the U.S. generally accepted accounting principles (GAAP) demand enhanced disclosure and reconciliation. Moreover, cross-listed firms face more scrutiny from international investors, more pressure to provide guidance and scrutiny from international auditors than they would have in their home markets. Cross listing, therefore, is a credible

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<sup>3</sup> For instance, Ferreira and Matos (2008) document empirical evidence that foreign institutional investors exhibit strong preference for firms that are cross-listed on a U.S. exchange, and have external visibility, high foreign sales and analyst coverage.

commitment to increased disclosure. A cross-listed firm cannot easily renege on its commitment if later on it turns out to have some undesirable bad news to hide. From a reputational standpoint, it would cost the firm dearly if the firm opts for de-listing from a foreign stock market because the firm will be alienating its international investor base. Moreover, a commitment to increase a firm's disclosure level, *per se*, should lower the information asymmetry component of the firm's cost of capital (Leuz and Verrecchia, 2000).

Doidge, Karolyi, and Stulz (2004) point out that cross listing can offer the firm access to more capital markets, thus a lower cost of capital, a larger shareholder base, a higher liquidity of stock, and a reduction in risk premium. Cross listing in a more stringent legal protection regime (such as the U.S.) restricts the controlling shareholder's ability to extract private benefits from the firm. The fact that a firm opts for cross listing therefore indicates that the controlling shareholder commits to lower consumption of private benefits of control. This is especially desirable when firms have valuable growth opportunities that cannot be exploited without raising external funds. Doidge *et al* develop a model and find empirical evidence in support of such trade-off of giving up private benefits and capitalizing on the growth opportunities. They also document empirical evidence for a cross listing valuation premium (i.e., a higher Tobin's  $q$ ) for firms that cross list in the U.S. compared to firms that do not. Their findings suggest the valuation premium can be as high as 37% for firms that list on major U.S. exchanges, but would be smaller for over-the-counter listings and private placements. Moreover, such premium is *negatively* related to the level of investor protection in the firm's home country and persists after controlling for country-level factors and firm-specific characteristics.

In the case of Hong Kong sample firms of this thesis, there is higher proportion of cross-listing firms in the LargeCap firms group (75%) than the MidCap group (28%). The SmallCap firms group has the lowest proportion of cross listing (19%). This is consistent with the empirical evidence by Saudagaran (1988) who observes from his 223 sample firms from the U.S., Canada, Europe, and Japan that large firms are more likely to list abroad. His findings also indicate a positive correlation between the likelihood of foreign listing and each of the four variables, namely, the relative size of a firm in its domestic capital market; the proportion of its revenues generated in foreign countries; the percentage of its long-lived assets that are invested abroad; and the relative number of employees in

foreign subsidiaries. More detailed description of the characteristics of the Hong Kong sample firms will be presented in Chapter 5.

#### **4.2.5 Section summary**

This section has presented a review on literature discussing the inter-relationships between legal regime, CG framework, and the development of financial markets institutions. It has discussed literatures arguing that the survival of the capital market hinges upon the legal protection of investors. When the law does not provide minority investors with adequate protection from the expropriation of majority shareholders, investors will refrain from investing in the capital market. The capital market shrinks thus affecting the economy as a whole.

Legal regime (i.e., the law and the quality of its enforcement) is important to minority shareholders because it specifies the rights the security holders have and determines how well these rights are protected. As stated by LLSV (2000a), investors use these rights to exercise their statutory power to change directors, force dividend payments, stop managers from indulging in self-interested projects, sue directors and get compensation, and liquidate the firm and receive the residual proceeds. Strong legal regime can enforce these rights better than weak legal regime. Hence, investor protection is higher in strong legal environment.

Comparatively, the legal protection of minority shareholders is generally more effective in countries with common law origin than with civil law origin. In common law courts, the judges tend to interpret the laws in light of the circumstances of the law case rather than follow the rules doggedly. They adjust the laws with time to ever-changing socio-economic conditions. Prior research supports the view that differences in legal protection of minority shareholders account for much of the cross-country differences in ownership and CG variations of firms.

Prior research also establishes that culture of an economy is a factor that influences the level of legal protection offered by that economy. The openness of an economy to international trade is also positively correlated with enforcement of creditors' rights. This study uses listed firms in Hong Kong as samples. Hong Kong has a common law legal origin mainly transplanted from the U.K. Its population is 95% Chinese whose tradition and culture do not encourage high level of voluntary disclosure. Yet, Hong Kong is the

world's 12<sup>th</sup> largest trading economy. It appears that the characteristics of Hong Kong mentioned above have both a positive and negative effect on investor protection for minority investors. It is against this background that this study examines the voluntary disclosure of CG of Hong Kong firms and its effect on firm valuation.

This section also discusses other non-legal measures such as analysts following, dividend payout, dual listing, and voluntary disclosure of CG mechanisms that are commonly considered as useful in enhancing outsiders' protection. Analyst following helps to reduce the information asymmetry between the insider and outsider investors. Dividend payout is used as a means by the minority shareholders to exert a demand for a reasonable return on their investments in the securities of a firm. The extent of voluntary disclosure of the CG of a firm is a signal to the minority shareholders whether the firm is committed to treat its shareholders, majority or minority, in a fair and equitable manner. A firm's determination to install and voluntary disclosure of information about its CG mechanisms on top of the mandatory requirements can serve a valid proxy to the management's commitment to a high standard of the firm's CG. Dual listing, on the other hand, signals to the investors the firm's willingness to be subjected to additional set of (and usually more stringent) reporting standards and disclosure requirements imposed by an extra stock exchange. These non-legal measures can be used as indicators of an enhanced level of investor protection.

The following section, Section 4.3, will review previous literature on a firm's voluntary disclosure, which is defined in this study as the disclosure of internal information of a firm not mandated by the legal regime but is made voluntarily by the corporate managers in its annual reports. Lang and Lundholm (1993) observe that some firms' annual reports "go well beyond the required disclosures, while others are extremely stark" (*ibid*, 1993, p. 246). As its name suggests, voluntary disclosure is non-mandatory but is often costly. Section 4.3 will explore the rationale for such behaviour by the managers by introducing the various theories as proposed by extant researchers, and presents the ways to measure the voluntary disclosure specifically related to a firm's CG.



## 4.3 Voluntary disclosure of a firm's corporate governance

### 4.3.1 Motivations for voluntary disclosure

Classic agency perspective depicts that the separation of corporate managers from outside investors involves an inherent conflict (Fama and Jensen, 1983b; Bushman and Smith, 2001). Being the insiders, managers possess superior information about the firm that is unknown to the outsiders. When the owners of modern firms are not the managers that run the day-to-day business, information asymmetry arises. As discussed previously in Section 4.2, corporate disclosure of such information is critical for the functioning of an efficient capital market. Therefore, the demand for information, both stipulated by regulations and voluntarily released by insiders, arises from information asymmetry and agency conflicts between managers and outside investors (Healy and Palepu, 2001, p. 406).

Research studies have tried to understand the relationship between mandatory disclosure, voluntary disclosure and their relationship with a firm's value. Disclosure is seen as a signal of firm value (Hughes, 1986). Better disclosure "can increase investor awareness of the firm, hence reduce the cost of capital and increase equity valuation" (Berglof and Pajuste, 2005, p.182). If any disclosure beyond the mandated minimum is defined as "voluntary" disclosure, the study of voluntary disclosure literature "appears to offer the greatest opportunity for large increases in our understanding of the role of accounting information in firm valuation and corporate finance"(Core, 2001, p. 442).

Healy and Palepu (2001) identify six motives that affect manager's disclosure decisions for capital market reasons: (i) capital markets transactions hypothesis; (ii) corporate control contest hypothesis; (iii) stock compensation hypothesis; (iv) litigation cost hypothesis; (v) management talent signalling hypothesis; and (vi) proprietary cost hypothesis. Each hypothesis is discussed in turn as follows.

#### (i) Capital markets transactions hypothesis

This hypothesis suggests that managers will voluntarily disclose more if they have the need to make capital market transactions, e.g., to issue public debt or equity, or to acquire another company. Managers do so because they want to reduce the information asymmetry problem, thereby reducing the firm's cost of external financing. This hypothesis is supported by empirical studies by Lang and Lundholm (1993, 2000). They document that when firms are going to issue securities in the current and future periods,

there is a significant increase in disclosure beginning six months before the offering. The increase in disclosure relates particularly to the categories of disclosure over which the firms have the most discretion. Such disclosures are always welcome and would receive higher ratings by the analysts. Similarly, Healy, Hutton and Palepu (1999) state that firms with increased analyst ratings of disclosures are found to have an abnormally high frequency of subsequent public debt offers. The voluntary disclosures always seem to precede public offerings of either equities or debts. The above-mentioned studies lend support to the argument that voluntary disclosure aims at reducing the information asymmetry between the insiders and the outsiders.

(ii) Corporate control contest hypothesis

Either explicitly stated or implicitly implied in all managerial compensation contracts, boards of directors and investors will hold managers accountable for current stock performance. Directors' duties are to supervise the managers, provide advice, and veto poor decisions. The board of directors is the investors' "first line of defence against incompetent management" (Weisbach, 1988, p. 432), and by the power invested by the shareholders, the board has the responsibility to hire, fire, evaluate, and compensate the Chief Executive Officer (Jensen, 1993). It follows that the CEO turnover of a firm is linked to the poor performance of performance of its stock (Warner, Watts, and Wruck, 1988).

However, Weisbach (1988) argues that the relation between the turnover of CEO and firm value may differ, depending upon whether the board of directors is dominated by insiders or outsiders. In the outsiders-dominated board scenario, Weisbach documents evidence to support a significant relationship between a rise in firm value and the resignation of CEO due to poor performance; whereas no similar relationship is found for boards that are dominated by insiders or boards that are mixed. Weisbach reports that performance measures (i.e., stock returns of the firms in his study) are more highly correlated with CEO turnover for firms in which outsiders dominate the board than for firms in which insiders dominate. Based on his empirical tests, he concludes that outsiders-dominated boards engage in monitoring of the managers that improves firm value. His findings make it all the more interesting to find out whether, in family-owned firms with entrenched managers who are family members of the predominant shareholders, outside directors are able to enhance firm value through effective monitoring of the managers.

According to Hermalin and Weisbach (1991), outsiders are added to the boards as external directors when the firms are performing poorly. Ownership and board changes are strongly related to subsequent top executive turnover (Denis, Denis and Sarin, 1997). When managers are faced with the risk of job loss which often arises from poor stock/earnings performance, they are expected to adopt measures including voluntary disclosures to reduce the likelihood of under-valuation and to explain away poor earnings performance.

This hypothesis for voluntary disclosure assumes that the board of directors will act diligently for all shareholders in monitoring the performance of the managers of the firm. In the case of family-owned firms where managers and majority shareholders also come from the same family, repeatedly poor firm performance may not necessarily cause executive turnover as frequently as expected. The risk of job loss is considerably less to the family-member managers than the ones who are employed professionally but have no family connection with the firm. Consequently, firms managed by family members may have weak motives for voluntary disclosure attributable to the fear of job loss.

#### (iii) Stock compensation hypothesis

Managers are often rewarded with stock-based compensation plans with the objectives to align their interests with the shareholders' interests. These plans, which may include stock option grants or stock appreciation rights, may provide incentives for managers to disclose voluntarily. First, managers rewarded with stock-based compensation are interested in trading their stock holdings. They have incentives to make opportunistic voluntary disclosures to correct any mis-valuation of their stock prior to the expiration of their stock options awards (Aboody and Kasznik, 2000). Second, by making voluntary disclosures, managers reduce contracting costs for new employees who are also entitled to stock compensations. Had there been any mis-pricing of the stock, stock-based compensation scheme may not be an efficient form of remuneration and the employees may demand additional compensation for bearing any risk associated with mis-valuation (Miller and Piotroski, 2000).

#### (iv) Litigation cost hypothesis

Voluntary disclosure by managers under this hypothesis suggests that managers do so for fear that various stakeholders may take legal actions against them for untimely or inadequate disclosures (Skinner 1994, 1997). On the other hand, litigation can potentially reduce managers' incentives to provide *more* disclosure, particularly of forward-looking

information such as earnings forecasts. Legal system cannot distinguish effectively between unexpected forecast errors due to chance or due to deliberate management bias. If managers believe that the legal system penalizes forecasts made in good faith, they will tend to refrain from making voluntary disclosure.

Empirical evidence on the litigation cost hypothesis is, however, mixed and inconclusive. Francis, Philbrick and Schipper (1994) find empirical evidence that contrasts Skinner's (1994) hypothesis. Out of 45 litigation samples, they find 28 cases (i.e., 62%) were based on an earnings forecast or a pre-emptive earnings disclosure, rather than on earnings announcement. Out of 53 no-litigation firms, 46 firms (i.e., 87%) with comparable stock price declines actually announced an earnings decline in prior. Pre-disclosure does not seem to be a deterrent to litigation.

(v) Management talent signalling hypothesis

Trueman (1986) proposes a theoretical model which states that, by releasing an updated earnings forecast due to changes in the firm's economic conditions, investors will assess more favourably the manager's ability in recognizing such changes. Trueman's underlying assumption is that the firm's market value at the end of any period is a function of investors' perception of the manager's ability to anticipate future changes in the firm's economic environment and adjust the firm's production plan accordingly. It follows that the manager will be motivated to release earnings forecasts regardless of whether they are of good news or bad news. Trueman's argument rests on the presumption that the manager's disclosure is not because of the *nature* of the revised expectation on the firm's earnings in a period but rather is the manager's *desire* to inform investors that he or she has received new information about the period's earnings. As commented by Healy and Palepu (2001), so far there is no empirical evidence to either support or refute this hypothesis.

(vi) Proprietary cost hypothesis

This hypothesis states that firms' decision to disclose information is influenced by the concern that such disclosures can damage their competitiveness in the product market. If there is potential threat against their competitive positions, firms will have an incentive not to disclose proprietary information (Verrecchia, 1983; Wagenhofer, 1990; Darrough and Stoughton, 1990; Feltham and Xie, 1992; Darrough, 1993; Gigler 1994).

Proprietary cost hypothesis differs from the previous five hypotheses in that it assumes there are no conflicts of interest between managers and shareholders. Disclosure will always be credible, and therefore the costs and benefits of disclosure, and the economic forces that constrain full disclosure, are the focus of attention under this hypothesis.

Notwithstanding the motives and incentives from the insiders in making disclosures, it can be concluded from empirical research findings that voluntary disclosure does have an impact on firms with respect to three areas: (i) improved stock liquidity (Welker, 1995; Healy, Hutton, and Palepu, 1999; Leuz and Verrecchia, 2000); (ii) reduced cost of capital (Botosan, 1997; Botosan and Plumlee, 2002) and (iii) increased information intermediation (Bhushan, 1989b; Lang and Lundholm, 1993; Francis, Hanna and Philbrick, 1998).

In his literature review paper on disclosure, Verrecchia (2001) comments that a truly comprehensive theory of disclosure should recognise the roles of *efficiency*, *incentives*, and *the endogeneity of the market process* because it involves interactions among diverse investor agents (*ibid*, 2001, p.100). Information asymmetry inhibits investment, making it more costly for a firm to engage in business activities (*ibid*, 2001, p.173). Through the reduction in the information asymmetry component of the cost of capital, disclosure is linked to efficiency, incentives, and the endogeneity of the market process. A commitment to greater disclosure will reduce information asymmetry.

#### **4.3.2 Measurement of voluntary disclosure of corporate governance structure and practices**

Section 4.3.1 has explored the motivations for a firm's voluntary disclosure as identified by various researchers. Although the subject content of these studies mainly focuses on the manager's voluntary disclosure of earnings forecast and/or segment reporting, the same hypotheses, principles, and theories can serve the study of a firm's voluntary disclosures of corporate governance (CG) equally well. Like earnings forecast or segment reporting, the information of a firm's CG practices is useful to outside investors. Unlike voluntary disclosure of earnings forecast or segment reporting which can be explicitly measured and quantitatively reported, there is a lack of consensus in the measurement of a firm's CG (Bhagat and Bolton, 2008, p. 259).

In CG disclosure studies, it is common to use a metric to proxy the degree of disclosure. For instance, Gompers, Ishii, and Metrick (2003) construct an equally weighted governance index of 24 corporate governance provisions compiled by the Investor Responsibility Research Centre (IRRC). Those provisions are largely about anti-takeover provisions such as the presence (or absence) of poison pills (i.e., blank check preferred stock), golden parachutes, classified boards, cumulative voting rights, and super-majority rules in approving mergers. Gompers *et al* examine the firm's reported profile in the IRRC books and code all provisions as simply "present" or "not present" (*ibid*, 2003, p. 113) to construct their governance index. For every firm, they add one point for the presence of every provision that restricts shareholder rights (i.e., increases managerial power). The governance index is then the sum of points for the existence of each provision. It has a possible range from 1 to 24; thus a higher index will be implying more restrictive shareholders' rights.

Similarly, Cremers and Nair (2005) classify the firm-level governance provisions into internal mechanism and external mechanism. For example, institutional blockholders and the board of directors are regarded as internal mechanism. Takeovers and the market for corporate control are considered as external mechanism. Cremers and Nair then construct an alternative takeover index to proxy a firm's governance. The index consists of 3 components that are critical to takeovers, namely, the existence of classified boards, poison pill, and restrictions on shareholders to call special meetings. Cremers and Nair deduct one point for the presence of each component so that the index has a value ranging from 0 to 3, with a lower value implying higher protection against takeovers and hence a lower quality of external governance. Their empirical findings show that the external mechanism does not operate alone. Internal and external governance mechanisms work together as complements to affect a firm's governance, and are empirically associated with long-term abnormal returns of the firm (*ibid*, 2005, p. 2862).

The measure for corporate governance disclosure in both studies by Gompers *et al* (2003) and Cremers and Nair (2005) only captures the disclosure of a small part of a firm's CG practice, namely, the anti-takeover mechanisms. Other studies tend to adopt a composite index approach by incorporating the disclosure of other attributes of a firm's governance. For example, Ho and Wong (2001) employ a survey questionnaire and the feedback from a sample of 92 financial analysts and 98 Chief Financial Officers to identify 20 CG attributes that a firm should voluntarily disclose in the annual reports. Equal weighting is then

assigned to each attribute that is disclosed to come up with an “importance-adjusted relative disclosure index” (RDI). The RDI is computed by dividing the actual number of attributes disclosed by the maximum possible number of disclosure for a firm (i.e., net of those attributes not relevant to the firm’s business) to proxy for the overall state of voluntary disclosure.

Not all disclosure studies assign equal weighting to each corporate governance attribute or provision, however. For example, Klein, Shapiro and Young (2005) adopt the governance index prepared by the Canadian *Globe and Mail* newspaper in their investigation of CG disclosure, family ownership, and firm value of Canadian companies. The overall index has a maximum value of 100, and is computed by summing four sub-indices: (a) board composition, (b) shareholding and compensation policies, (c) shareholder rights policies, and (d) disclosure policies. Weights of 40, 23, 22, and 15 per cent are assigned to these four sub-indices respectively. The Report on Business (ROB) section of *The Globe and Mail* claims to have developed such measures based on a “tough set of best practices culled from the corporate governance guidelines and recommendations of U.S. and Canadian regulators, as well as major institutional investors and associations” (McFarland, 2002, p. B6).

It can be seen from above discussion that various users of annual reports may accord different significance to various corporate governance attributes. Moreover, the significance of the attributes to the same user may vary over time. There has not been a theoretical basis to justify unequal weights assigned to sub-indices or elements within each sub-index. As such, current researchers tend to assign equal weighting to each attribute in their corporate governance disclosure study (e.g., Black, Jang, and Kim, 2006; Bhagat and Bolton, 2008). Consequently, this study will adopt an equal weighting approach in constructing the voluntary CG disclosure score (CGDscore) to measure the sample firms’ disclosure in their annual reports (more description on CGDscore will be presented in Chapter 8).

#### **4.3.3 Section summary**

The voluntary disclosure of CG structure and practices of Hong Kong firms can best be studied in light of the characteristics of the firms, the overall legal and accounting regimes of Hong Kong, and the relationship of disclosure and the firm valuation. It has already been discussed in Section 3.4.1 that the main incentive for voluntary disclosures is to

reduce the information asymmetry between the insiders and outsiders of the firm, thereby lowering the firm's cost of external capital. It follows that, for those firms with small capitalization that do not have access to cheap, external capital, voluntary disclosures about the firms' CG may be an easy way to obtain such funding. Even for the medium/large capitalization firms where cheap external funding may not be a major concern, voluntary disclosure of their CG practices may help alleviate the litigation risks, reduce the volatility of stock price fluctuations, and enhance the management talent signalling effects which will have an impact on the firms' valuation. A study of the extent of voluntary CG disclosure by the firms, and the variations in the CG disclosure across the firms, has significant economic and policy values.

This concludes the discussion in Section 4.3. The following section, Section 4.4, reviews the literatures by prior researchers who have identified some variables that can also affect the internal CG of a firm. These variables are related to the firm characteristics, rather than the socio-economic or legal environments. They are discussed in the next section because prior research has used them as control variables. Some of these variables will also be selected as control variables in the empirical models of this study.

## 4.4 Other firm characteristics variables affecting internal corporate governance

### 4.4.1 Firm-specific business variables

As has been previously discussed in Section 4.2.4, researchers have identified four indicators of investor protection as measures to gauge a firm's state of corporate governance (CG). They are, namely, analyst following, dividend payout, the extent of voluntary disclosure, and dual listing of the firm. Useful as they may seem to the outside investors, these indicators *describe* the state of a firm's governance. They are not the factors that *drive* the management to achieve the state of governance within the firm.

Prior theoretical CG studies have suggested other variables that may exert influence on the firm's management in designing and implementing the firm's internal corporate governance system. For instance, Himmelberg, Hubbard and Palia (1999) identify seven variables that proxy for the firm characteristics influencing a firm's contract environment



with the managers and the scope for managerial discretion, which in turn affect the state of a firm's CG. These variables include:

- 1) firm size;
- 2) capital intensity;
- 3) free cash flow;
- 4) R & D intensity;
- 5) advertising intensity;
- 6) gross investment rates; and
- 7) market power.

Such variables are useful in the analysis because they are observable variables that "relate to potential moral hazard and influence optimal managerial stakes" (*ibid*, p. 362). Himmelberg *et al* claim that these variables drastically improve the  $R^2$  statistic in their empirical models. A brief introduction on some of the important variables is presented below.

Firm size (proxied by the logarithm of firm sales) is included as a control variable because it may have an effect *a priori* on the scope of moral hazard (*ibid*, p. 364). Large firms tend to have greater monitoring and agency costs. On the other hand, large firms are likely to employ more skilled managers who are consequently wealthier and may afford a higher level of managerial ownership. On the other hand, large firms' management and the rating agencies may enjoy economies of scale in monitoring, which leads to a lower optimal level of managerial ownership.

The capital intensity, proxied by capital-to-sales ratio, is used to control for the relative importance of fixed (or 'hard') capital in the firm's inputs. Gertler and Hubbard (1993) suggest that firms with a greater concentration of fixed capital will generally have a lower optimal level of managerial ownership. Gross investment rate, as measured by the ratio of capital expenditures to the capital stock, is to control for the possible link of high growth and opportunities for discretionary projects. The ratio of operating income to sales is employed to measure market power. The free cash flow (being the difference between cash flow and spending on value-enhancing investment projects), also serves as a proxy for market power (Jensen (1986) suggests that the higher is a firm's free cash flow, all else being equal, the higher is the desired level of managerial ownership).

While the above seven variables may be pertinent to Himmelberg *et al*'s (1999) study, others researchers offer other selection of explanatory variables that account for differences in a firm's performance and its corporate governance. For instance, Short and

Keasey (1999) classify their explanatory variables into (i) ownership variables and (ii) control variables in explaining the relationship between the managerial ownership and the performance of firms:

- (i) Ownership variables:
  - a) Percentage of shares held by directors;
  - b) Percentage of shares owned by institutions owning 5% or more;
  - c) Percentage of shares held by other external ownership interest.
- (ii) Control variables (to control for other potential influences on the performance of firms):
  - a) Firm size (proxied by the logarithm of total sales);
  - b) Sales growth;
  - c) Debt ratio;
  - d) Research & development expenditure scaled by total assets.

Firm size is a control variable because it has potential to affect a firm's performance through 2 avenues: (a) financing effect and (b) entry barriers. Larger firms may find it easier to generate funds internally and to access funds from external sources. When the cost of capital is reduced, a larger firm may be allowed to invest into more profitable projects. On the other hand, the larger firms enjoy economies of scale which help create entry barriers to potential competitors. Both will lead to beneficial effects on the firm's performance.

Sales growth is used to control for the impact of the growth on the firm's performance and for the potential linkages between the firm's performance, financing structure, and growth (Morck, Shleifer and Vishny, 1988; McConnell and Servaes, 1995).

The debt ratio is included to control for the possibility that the debt-holders exert influence over the operation and behaviour of the firm's management (Stiglitz, 1985). Also, debt is often used by management to signal to the market that the managers have committed themselves to generating a sufficiently high level of cash flow for repayment purposes (Grossman and Hart, 1982; Jensen, 1986). Debt has a corporate governance function that resolves conflicts between managers and shareholders in reducing management discretion to consume excessive perquisites, hence enhancing the firm's value (Jensen and Meckling, 1976; Grossman and Hart, 1982).

Research and Development expenditure is suggested as a control variable to control for the firm's intangibles and potential for growth in the future. However, data on Research &

Development expenditure, like those on Advertising expenditure, are not readily available or disclosed in the annual reports of the firms in some markets like Hong Kong (or the U.K.). Moreover, most of the market index constituent firms in Hong Kong engage in trading and real property development. They seldom invest in Research and Development activities of their own initiatives, which explains why the investment in Research and Development is either not disclosed or at a low level (reported as a percentage of their total sales). A more in-depth of the explanatory variables for this thesis will be presented in Chapter 7.

#### **4.4.2 Outside directors and board composition**

Recent corporate governance studies emphasize the internal control of the firm and suggest that a check and balance mechanism should be installed to counteract the influence of a dominant chairman/ chief executive. The presence of independent outside directors (or Independent Non-Executive Directors, INEDs, also referred as outside directors), and the proportion of these INEDs on the board of directors, is generally considered as a proxy for the independence of the board of directors from the influence of an all-powerful Chairman /CEO. For instance, Fama (1980), Fama and Jensen (1983b), and the U.S. Securities and Exchange Commission (1980) acknowledge that outside directors play the role of monitors of management and “providers of relevant complementary knowledge” (Fama and Jensen, 1983b, p. 315). Based on a comparative study of two leading U.S. manufacturers and two Japanese manufacturers, Yoshimori (2005) concludes that the independence of outside directors (i.e., INEDs) is a crucial aspect of the governance of a firm. He cautions that a self-interested CEO can undermine the independence of outside directors by means of high director remuneration, lucrative consulting and other pecuniary compensation.

Weisbach (1988) reports that CEO turnover is more highly correlated with firm performance in firms where a majority of outside directors are present, than in those where insiders predominate. The implication is that outside directors are important in monitoring management. Hermalin and Weisbach (1988) find that outsiders are more likely to join a board after a firm performs poorly or leaves an industry. It indicates that outside directors are useful for providing guidance when a shift in strategy is needed. An alternative explanation is that the addition of an outside director signals a change in firm strategy rather than the benefits of outside guidance.

While there appears to be consensus that the independent directors have an influential role in monitoring the management of a firm, there has been inconclusive evidence that board composition will improve firm performance unilaterally. Brown and Caylor (2004) report positive correlation between the Institutional Shareholder Services (ISS) governance index and several measures of firm value and performance; and that “the sub-part of the ISS index that seems to be most important is the one based on board composition” (as quoted in Bebchuk and Cohen, 2005, p. 430). In a subsequent paper, Brown and Caylor (2006) argue that it is not so much as the *composition* of the board that is related to firm value but the three factors related to the *behaviour* of the board of directors that is empirically found to be linked to firm valuation, which they suggest to be: (i) all directors attended at least 75% of board meetings or had a valid excuse for non-attendance; (ii) board members are elected annually; and (iii) board directors are governed by stockownership guidelines and other guidelines in each proxy statement. In this study, the computation of CG disclosure score (CGDscore) captures the attendance of the board directors (i.e., if individual director’s attendance rate is disclosed in the annual reports); while the number of INEDs and the proportion of INEDs on the board are treated as control variables. More discussion of the computation of CGDscore will be discussed in Chapter 8.

## 4.5 Summary

This chapter summarizes and discusses the extant literature on the relationship between legal protection, corporate governance, and voluntary disclosure. The pioneering studies via the legal approach to corporate governance employed by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998, 2000a) and Roe (2002) firmly establish that protection of investor rights is the cornerstone for the functioning and development of a country’s financial market. Legislation and the enforcement of the law are equally important to protect minority shareholders, bondholders, institutional investors and other suppliers of funds from potential exploitation by the majority shareholders. As concentration of ownership outside the U.S., U.K., and Japan seem to be the norm rather than the exception, the protection of minority outsiders from potential tunnelling by the majority shareholder and misuse of investors’ funds by the insiders becomes a major concern for modern day businesses.

While legal protection may help deter such wrong doings by the predominant shareholders, there are many ways for a predominant shareholder to legitimise the acts of serving his/her self-interests at the expense of minority shareholders. Particularly in the context of tightly controlled family business environment (such as Hong Kong), outsiders rely on the voluntary disclosure by the insiders to assess the state of the corporate governance that is installed within the firm. Other proxies that may infer the quality of corporate governance and thus enhance outsiders' confidence include the number of analyst following, dual listing, and dividend payout. When the investors do not feel adequately protected, they will refrain from investing into the firm, leading to more concentrated ownership and a low market valuation of the firm.

In this study, Hong Kong firms are used as samples to examine the relationship between voluntary disclosure of corporate governance and firm valuation. In the following chapter, Chapter 5, a discussion of the general Hong Kong corporate governance and reporting framework, the Hong Kong stock market, and the characteristics of Hong Kong listed companies will be made, prior to the presenting the hypotheses in Chapter 6.

# Chapter 5: Corporate Governance and Corporate Financial Reporting in Hong Kong

## 5.1 Introduction

This thesis studies the impact of voluntary disclosure of corporate governance (CG) practices on the valuation of Hong Kong listed firms. To put this study into context, it is necessary to have an understanding of the historical development of the disclosure requirements for Hong Kong firms and the reporting regulations. It is also necessary to have an appreciation of the evolvement of the CG framework in Hong Kong up to 2005, when the new *Listing Rules* of the Hong Kong Exchange (HKEx) became effective. This new set of *Listing Rules (2005)*, unlike previous ones, stipulates a formal Corporate Governance Report to be published by all issuers of securities that are floated on the HKEx.

This chapter presents the background and the historical development of the CG framework of Hong Kong. Section 5.2 will first introduce the Hong Kong financial reporting framework. It summarizes the historical development of financial reporting standards and regulations since 1973, the year when the Hong Kong Society of Accountants (HKSA) was founded. The HKSA was the professional organization recognised by the then Hong Kong Government to provide consultations and advice on accounting and auditing standards, and financial reporting regulations.

Section 5.3 presents the legal aspect of the CG framework in Hong Kong. Two ordinances (i.e., laws as they are referred to in Hong Kong), namely, *the Companies Ordinance* and *the Securities and Futures Ordinance*, are summarized and discussed. These two ordinances are the core regulations that govern the behaviour of firms that are floated on the HKEx. Section 5.4 traces the evolution of the CG framework up to 2005, when the recommended practices of CG disclosure by the listed firms were first codified into provisions. It also presents the stages of development of how the Hong Kong Government's concern for the overall governance of the capital market culminated into a formal 'Corporate Governance Report' requirement as stipulated by the HKEx *Listing Rules (2005)*. The institutional framework of Hong Kong's securities and capital market will be presented in Section 5.5. Section 5.6 follows with a description of the general characteristics of the Hong Kong stock market, based on a review of literature by prior researchers. Section 5.7 summarizes the chapter.

## 5.2 The financial reporting framework in Hong Kong

Hong Kong had been under the British rule for 150 years when it was returned to China in 1997. It is well documented in research literature that Hong Kong has a well-developed and liberal financial system, modelled on the British reporting framework (Phenix, 1994, Wallace and Naser, 1995). Traditionally, the corporate financial reporting in Hong Kong was guided by two sources:

- (i) *the Hong Kong Statements of Standard Accounting Practice* (HKSSAPs)<sup>1</sup> issued by the Hong Kong Society of Accountants (HKSA)<sup>2</sup>; and
- (ii) *the Hong Kong Companies Ordinance* (as company laws are referred to in Hong Kong).

The HKSSAPs follow closely the financial reporting standards in the U.K. Similarly, the Companies Ordinance was modelled on British company law prior to 1997 (Phenix, 1994, p.164-165). Before the formation of HKSA in 1973, British influence dominated in accounting training, education and practices. Prospective accountants in Hong Kong acquired their professional qualifications through gaining membership of overseas professional accounting bodies of the U.K. (or other Commonwealth countries) by examination. From 1973 to 1982, the HKSA issued non-mandatory accounting standards, which were essentially re-issues of the U.K. accounting standards. From 1982 onwards, the HKSA was authorized to set the formal accounting standards (HKSSAPs) based on the U.K. standards (*ibid*, 1994).

The HKSA has played a significant role in setting financial reporting standards for Hong Kong firms. One of the HKSA committees, the Professional Standards Monitoring Committee, worked with the Stock Exchange of Hong Kong (SEHK)<sup>3</sup> in reviewing the financial statements of Hong Kong listed firms. The HKSA expected its members to comply with the HKSSAPs when preparing the accounting statements, thus exercised authority over its members in doing so. Such authority was reinforced by the Hong Kong Companies Ordinance, which requires all Hong Kong firms' financial statements to be presented and audited by a Hong Kong Certified Public Accountant (HKCPA), a qualification conferred by the HKSA to its members who have fulfilled the requirements of on professional examinations and experience (Phenix, 1994, p.189).

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<sup>1</sup> Later known as the Hong Kong Financial Reporting Standards (HKFRSs).

<sup>2</sup> Renamed as the Hong Kong Institute of Certified Public Accountants (HKICPA) after September 2004.

<sup>3</sup> Later known as the Hong Kong Exchanges and Clearing Ltd (HKEx).

On one hand, the U.K. accounting standards have been increasingly influenced by harmonization within the European Union. On the other hand, businesses in Hong Kong have developed close ties with Mainland China, whose national accounting standards are yet developing. As a compromise, the HKSA started to shift to International Accounting Standards (IAS)<sup>4</sup> for future guidance. In 1992, the HKSA officially switched to IAS as the models for future accounting standards and guidelines (Ball, Robin, and Wu, 2003, *Appendix A*).

The HKEx also stipulated in its listing requirements that the annual accounts of listed firms should comply with the HKSSAPs or, if the company was registered outside Hong Kong, it must comply with the International Accounting Standards (IASs) issued by the International Accounting Standards Committee (IASC)<sup>5</sup> (Phenix, 1994, p. 185). Listed firms must adhere to the standards set by either of the above accounting bodies and apply the standards consistently and shall not change from one body of standards to the other (HKEx, *Listing Rules 2005, Chp. 4: Accountants' Reports and Pro Forma Financial Information*; and *Appendix 16: Disclosure of Financial Information*).

Appendix 16 of the *HKEx Listing Rules (2005)* requires all listed firms in Hong Kong to present financial statements in their annual reports with the following minimum financial information:

- (1) Balance sheet;
- (2) Income statement;
- (3) Cash flow statement;
- (4) Statement of changes in equity;
- (5) Comparative figures for the statements;
- (6) Accounting policies and explanatory notes.
- (7) A separate Corporate Governance Report prepared by the board of directors on its corporate governance practices. The report must, as a minimum, contain “information required under Appendix 23 regarding the accounting period covered by the annual report” (*HKEx Listing Rules*, para. 34); and
- (8) A statement of sufficiency of public float based on information “that is publicly available to the listed issuer and within the knowledge of its directors as at the latest practicable date prior to the issue of the annual report” (*HKEx Listing Rules*, para. 35).

Item 7 as stated above (i.e., the Corporate Governance Report) is a newly added requirement to the *Listing Rules*. All listed firms are required to include a separate report

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<sup>4</sup> Later known as the International Financial Reporting Standards (IFRSs).

<sup>5</sup> Later renamed as the International Accounting Standards Board (IASB).



on their state of corporate governance in their annual reports starting from the fiscal year beginning 1 January 2005 or after. Corporate governance was thus officially recognised, and regarded as an integral part of the minimum disclosure on the performance of the listed firms, by the Hong Kong capital market facilitator. This change in the significance of a firm's CG as requirement in the HKEx *Listing Rules* from 2005 onwards, is the outcome of a series of consultation work with the listed firms, market participants, professional accounting bodies, accounting researchers, and other regulatory institutions over a decade. In the following section, a discussion on the involvement of the market players in setting the general overall corporate governance framework will be presented.

### 5.3 The legal corporate governance framework in Hong Kong

Prior to 2002, the laws and rules governing corporate disclosure of firms incorporated in Hong Kong were principally set out in five ordinances as stated below (*the Standing Committee on Company Law Reform Consultation Report*, SCCLR, 2001):

- (i) The Companies Ordinance which applies to all companies registered in Hong Kong;
- (ii) The Securities (Disclosure of Interests) Ordinance;
- (iii) The HKEx Listing Rules and the Growth Enterprise Market listing Rules which cover disclosure on director's remuneration, connected transactions, equity shares ownership etc.;
- (iv) The Code on Takeover and Mergers and Share Repurchases; and
- (v) The Hong Kong Statements of Standard Accounting Practice (HKSSAPs).

The SCCLR was formed in 1984 to advise the Financial Secretary on amendments to the Companies Ordinance and other related ordinances. In early 2000, three sub-committees were set up to review the state of corporate governance of Hong Kong firms: (i) the Corporate Reporting Sub-Committee; (ii) the Shareholders Sub-Committee; and (iii) the Directors Sub-Committee. Each sub-committee was to review the current statute law, administrative rules and regulations, and codes of practice relevant to its own area of investigation. The objective of the review was to enhance genuine accountability, disclosure and transparency, and thereby further improve CG standards, shareholder democracy, and communications (SCCLR, 2001).

The sub-committees had several missions. They were to reform and strengthen the non-statutory disclosure requirements in respect of listed companies as promulgated in the SEHK *Listing Rules*; strengthen the internal controls in companies with particular reference to internal audit functions; as well as define the roles and functions of Audit Committees (SCCLR, 2001, *Terms of Reference*). The role of disclosure was one of the key elements in corporate governance under study by these sub-committees. In specific areas of their own concerns, the sub-committees commissioned research projects to acquire data that would support them to propose recommendations of law reform on solid empirical grounds.

Based on the empirical findings and recommendations of the SCCLR, the Financial Secretary of the Hong Kong Special Administrative Region Government (HKSAR, being the official name of the government in Hong Kong after 1997) introduced amendments to the laws that regulated the business-reporting environment of Hong Kong. Reforms of the two flagship laws were made, namely, *the Hong Kong Companies Ordinance (Cap. 32)* and *the Securities and Futures Ordinance (Cap. 571)*. The following subsections 5.3.1 and 5.3.2 will give a brief introduction on these two ordinances respectively.

### **5.3.1 Companies Ordinance (Cap. 32)**

Originally promulgated in 1865 with amendments in 1911 and 1933 as *the Hong Kong Ordinance (Cap. 39)*, this ordinance acquired its present name as *the Hong Kong Ordinance (Cap. 32) – Companies Ordinance* – in 1950. It has been amended through the incorporation of many Companies (Amendment) Ordinances in 1984, 1988, 1992, 2003, and 2004 (HKSAR, *Companies Ordinance*, 2004). *The Companies Ordinance (CO)* provides the legal foundation for regulating the business behaviour of all firms in Hong Kong, including listed and private companies. The CO prescribes the proper procedures from formation to winding up of a business entity. It specifies the power and duties of directors. It also prescribes the rights of the shareholders in terms of the proceedings of voting at the general meetings.

Some sections of the CO do not apply to financial institutions and companies if the firms are formed under *the Banking Ordinance (Cap. 155)*, *the Insurance Companies Ordinance (Cap. 41)*, and any corporation licensed under Part V of *the Securities and Futures Ordinance (Cap. 571)*.

Modelled on similar company law in the U.K., the CO seeks to consolidate and amend the law relating to companies, and govern the formation, operation, and dissolution of private or public companies. It specifies the duties and rights of the directors and officers of a company, the appointment of auditors, and the obligations of the firm to provide a copy of balance sheet, directors' report, and auditors' report to every member of the firm not less than 21 days before the date of the general meeting of the company. As at 2008, *the Companies Ordinance* has 367 Sections and 24 Schedules.

### **5.3.2 Securities and Futures Ordinance (Cap. 571)**

Another legal provision that regulates the operation of the stock market and its participants is *the Securities and Futures Ordinance (Cap. 571)*, which was passed in the Legislative Council in March 2002 but commenced operation on 1 April 2003. This ordinance, SFO, consolidates all previous 10 securities and futures related ordinances (e.g., *The Securities (Insider Dealing) Ordinance (Cap. 395)*; *the Securities (Disclosure of Interests) Ordinance (Cap. 396)* etc.) into one single law. It is the primary ordinance that governs the securities and futures market of Hong Kong.

The SFO aims to establish a regulatory framework to meet international best practice and to enhance market efficiency and transparency (Tsui and Gul, 2002). It empowers the SFC to set up a Market Misconduct Tribunal (MMT) to handle some specified market misconduct such as false trading, price rigging, insider dealings by the firms, disclosure of false or misleading information inducing transactions, stock market manipulation, etc. It sets out penalties for their offences (Cap. 571, Sect.303). It also legislates the investors' rights. Through the establishment of a compensation fund, it provides compensation to those investors who sustain a loss by reason of a default committed by persons or firms breaching the securities or futures contracts (Cap. 571, Sect. 236). With respect to the disclosure requirements, this ordinance requires the directors and the chief executives of firms to disclose their interests in the company shares to listed firm and to the HKEx (Cap. 571, Sect. 341). It lowers the threshold of an investor's shareholding notifiable to the investee firm from 10% to 5% (Cap. 571, Sect. 315). It also reduces the time limit for notification from 5 days to 3 business days after the date of the relevant event occurs (Cap. 571, Sect. 325).

However, as comprehensively as it strives to protect investors in general, this ordinance does not provide any regulations relating to the proper governance of a firm. Prior to 2005,

the ways on how a listed firm should be governed were not legally stipulated, but were merely suggested as guideline in the *Code of Best Practice* incorporated in Appendix 14 of the SEHK (1998) Listing Rules. The *Code of Best Practice*, first introduced by the SEHK in 1993, outlined the best corporate practices in terms of the board composition, presence of independent non-executive directors, formation of audit committee, directors' access to information, appointment and removal of directors. It was not mandatory for the listed firms to adopt *the Code of Best Practice*, although member firms listed on the Main Board of the SEHK were strongly encouraged to adhere to it. In January 2005, *the Code of Best Practice* was eventually incorporated into part of the mandatory requirements of the *Listing Rules* of the HKEx (2005). This study makes use of the disclosure by listed firms from 2003 to 2005 in order to investigate the relationship between the firm's voluntary disclosure of its corporate governance (CG) practices and the firm's market valuation. The following section, Section 5.4, will discuss the evolvement of such corporate governance disclosure requirements up to 2005.

## 5.4 Corporate governance development and implementation in Hong Kong

Prior researchers have conducted cross-country studies on corporate governance (CG) for comparison. Some of these studies include Hong Kong as one of their sample countries. In Section 5.4.1 below, a summary of three empirical studies by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, 1998), Credit Lyonnais Securities Asia (CLSA, 2003) and Daouk, Lee and Ng (DLN, 2006) is presented. Although DLN's work was published in 2006, their source data were collected between 1969-1998. The findings of these studies provide a portrait of the stage of CG that Hong Kong had attained in comparison to other developed or emerging markets prior to 2005. Section 5.4.2 will present a descriptive account of the development and implementation of CG from the 1990s to 2005.

### 5.4.1 Corporate governance of Hong Kong prior to 2005

Individual firm's corporate governance practices are likely to be dependent upon the legal and regulatory framework of the jurisdiction within which the firm is operating, as well as the level of enforcement of laws and regulations on corporate governance of that jurisdiction. According to a cross-country legal protection and law enforcement study by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV) in 1998 (also repeated in Lemmon and Lins, 2003), Hong Kong ranks top in shareholder rights and shares the

highest rank with Japan and Singapore in the efficiency of judicial system in law enforcement compared with 8 other Asian countries:

Shareholder rights of 9 Asian countries in LLSV's (1998) Table 2

*(Lower scores represent lower anti-director rights; higher scores represent higher shareholder rights)*

1. <b>Hong Kong</b>	5
2. Japan	4
2. Malaysia	4
2. Singapore	4
5. Philippines	3
5. Taiwan	3
7. Indonesia	2
7. South Korea	2
7. Thailand	2

Efficiency of Judicial System scores of 9 Asian countries in LLSV's (1998) Table 5

1. <b>Hong Kong</b>	10.00
1. Japan	10.00
1. Singapore	10.00
4. Malaysia	9.00
5. Taiwan	6.75
6. S. Korea	6.00
7. Philippines	4.75
8. Thailand	3.25
9. Indonesia	2.50

Moreover, Hong Kong ranks the 4th highest in the rule of law and is placed at the middle in the risk of government expropriation (i.e. outright confiscation or forced nationalisation of business by the government). Unlike most other East Asian countries, Hong Kong adopts a *laissez faire* policy and government expropriation cases of private enterprises are few and far in-between over the past decades (except for banks and financial institutions that may cause havoc to the economy):

Rule of Law scores of 9 Asian countries in LLSV's (1998) Table 2

*(Lower scores correspond to less tradition for law and order)*

1. Japan	8.98
2. Singapore	8.57
3. Taiwan	8.52
4. <b>Hong Kong</b>	8.22
5. Malaysia	6.78
6. Thailand	6.25
7. S. Korea	5.35
8. Indonesia	3.98
9. Philippines	2.73

Risk of Expropriation by the government of 9 Asian countries in LLSV's (1998) Table 5  
*(Higher scores correspond to lower risk of expropriation by the government)*

1. Japan	9.67
2. Singapore	9.30
3. Taiwan	9.12
4. S. Korea	8.31
5. <b>Hong Kong</b>	8.29
6. Malaysia	7.95
7. Thailand	7.42
8. Indonesia	7.16
9. Philippines	5.22

However, in another cross-country study on capital market governance over the period 1969-1998 by Daouk, Lee and Ng (DLN, 2006), Hong Kong does not rank as high as other developed markets such as Japan, Singapore, South Korea, and Taiwan in the sub-sample of Asian countries that are examined (Indonesia and Philippines are not included in the original sample set). DLN compute a capital market governance (CMG) index based on 3 components: insider trading laws enforcement, earning opacity, and relaxation of short-selling restrictions.<sup>6</sup> The capital market governance (CMG) index is the simple average of these 3 measures and ranges from 0 (worst governance) to 10 (best governance). Hong Kong ranks the last third in terms of transparency, only slightly better than Thailand but still relatively better than Malaysia. Such low ranking assigned to Hong Kong may be due to the undeveloped state of corporate governance prior to the Enron debacle (2001) and the subsequent corporate governance reform jointly carried out by accounting and regulatory institutions and the Hong Kong SAR Government:

Capital Market Governance (CMG) Index of 7 Asian countries in DLN's (2006) Table 1  
based on data 1969-1998  
*(Higher scores indicate greater transparency)*

1. Singapore	7.96
1. Taiwan	7.96
3. Japan	6.40
4. S. Korea	4.49

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<sup>6</sup> In Daouk, Lee and Ng's self-constructed CMG index, *insider trading laws enforcement* follows a previous study by Bhattacharya and Daouk (2002) that captures the level of enforcement of insider trading laws. The variable is assigned a value of 10 if there had been any enforcement and 0 otherwise. *Earning opacity* is defined as "the extent to which the distribution of reported earnings of firms in that country fails to provide information about the distribution of the true, but unobservable, economic earnings" (DLN, 2006, p. 565). This variable ranges from 0 (most opaque) to 10 (least opaque). As for *short-selling constraint relaxation*, any decreases in short-selling constraints are reflected as improvements in the capital market governance index. The variable also provides for the existence of put options on stocks (because equity put options offer an alternative to implement a short position) and is assigned 0 if short-selling was not allowed and put options do not exist in a given time period, and 10 if short-selling is allowed or put options exist.

5. <b>Hong Kong</b>	3.83
6. Thailand	3.81
7. Malaysia	1.92

A country's ranking of corporate governance very much depends on the factors that shape the standard of CG as well as the weighting each factor receives in a study. For example, in a survey conducted by Credit Lyonnais Securities Asia (CLSA, 2003) on 10 countries in East Asia including Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, and China, there are 7 key criteria for evaluating the concept of good corporate governance with respective weightings as follows:

<u>Key criteria for Corporate Governance:</u>	<u>Weightings</u>
1. Management discipline	15%
2. Transparency in disclosure	15%
3. Board independence	15%
4. Accountability of the board of directors	15%
5. Fairness to non-majority shareholders	15%
6. Responsibility of the board of directors & management	15%
7. Fairness to non-majority shareholders	10%
	Total: <u>100%</u>

*(Source: adapted from CLSA CG Watch – Corporate Governance in Asia, April 2003, Appendix 1: CLSA CG methodology)*

In CLSA (2003) survey, Hong Kong ranks 3<sup>rd</sup> among East Asian countries in the overall corporate governance scores:

CLSA CG Watch April 2003 Appendix 3: Country average CG scores

S. Korea	70.8
Singapore	69.5
<b>Hong Kong</b>	65.9
Malaysia	65.0
India	64.8
Thailand	60.2
Taiwan	58.7
China	57.4
Indonesia	43.0
Philippines	39.8

All in all, though there is no consensus among extant researchers about the Hong Kong's CG ranking among Asian countries, the general evidence shows that Hong Kong stands relatively high in the overall CG framework. Under such a framework, individual firms in Hong Kong are given discretion to establish their internal CG mechanisms (which is the "balanced approach" – i.e., the comply or explain approach – as recommended in the final

report by the Standing Committee on Company Law Reform (SCCLR) in 2002 and was subsequently adopted by the Hong Kong Exchange in its listing rules in 2005). The above studies show that there is room for improvement in Hong Kong's CG practices for individual firms, particularly in the protection of minority shareholders and in enforcement of laws.<sup>7</sup>

Hence, it can be concluded that at the time these studies were made, there were no mandatory requirement on listed firms in Hong Kong to install CG mechanisms. Directors of firms could weave between the rules and push business deals through that were clearly against minority shareholders' interests. There were no class action suits<sup>8</sup> for minority shareholders to fight against injustice done to them by the firm's managers.

The Standing Committee on Company Law Reform (SCCLR, 2002) recommended a "balanced approach" regulatory framework in terms of CG disclosure, which was subsequently adopted by the HKEx in its Listing Rules 2005. This approach is similar to the "comply or explain" approach in the U.K. but differs from the prescriptive approach in the U.S. Before the CG framework was formally implemented in 2005, the HKEx informed and consulted with its listed members on the expected implementation of CG mechanisms and practices. A set of codes of recommended best practices (*the Code*) was introduced to the member-listed firms in 2002 with the objective to enhance their transparency and improve their CG disclosure to outside investors. Listed firms were allowed to opt for their own set up on CG mechanisms, and decide on the extent of their disclosure, for the period prior to the implementation date of the regulatory framework in 2005.<sup>9</sup>

This thesis investigates the effect of voluntary disclosure of CG mechanisms of Hong Kong listed firms on their valuation for the period 2003-2005, immediately before CG

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<sup>7</sup> In the SCCLR *Consultation Paper on Proposals made in Phase I of the Review* (July 2001), it was stated in the Terms of Reference of the Corporate Governance Review Directors Sub-Committee that "In the light of the predominance of controlling shareholder groups and the rights and interests of controlling shareholders; [and] the lack of shareholder activism as a natural force for improving corporate governance; ...[its terms of reference is] to review the current statute law, administrative rules and regulations and codes of practice relevant to the directors and boards of all companies incorporated or registered in Hong Kong with the objective of enhancing genuine accountability, disclosure and transparency, and thereby **further improving corporate governance standards**". (Emphases added)

<sup>8</sup> As per comments on Hong Kong's overall corporate governance in the CLSA CG Watch: *Corporate governance in Asia*, April 2003, p. 29.

<sup>9</sup> The HKEx recognised that the observance of good governance by the market as a whole was an important element in the perspective of local and overseas investors. It acknowledged the importance of raising the CG profile of Hong Kong amid the increasing competition from other marketplaces. It aims at promoting and enhancing the CG standards on a par with the evolving international standards (HKEx, *Annual Report* 2005).



disclosure became a mandatory disclosure requirement. In the following section, the historical development of CG and implementation of *the Code* will be presented, and the salient items of mandatory disclosure and recommended practices specified by the HKEx Listing Rules 2005 will be summarized.

#### **5.4.2 Corporate governance development and implementation in Hong Kong**

Hong Kong began to follow the lead of Western countries such as the U.S. and the U.K. in the early 1990s in developing and adopting CG concepts and practices (Chau and Leung, 2006). In 1993, the Stock Exchange of Hong Kong (SEHK)—later renamed as Hong Kong Exchanges and Clearing Limited (HKEx)—set up the first Working Group on Corporate Governance in conjunction with the Hong Kong Society of Accountants (HKSA). Its task was to analyse and advise on the relevancy of the U.K. *Cadbury Report (1992)* to Hong Kong. By the end of 1993, the SEHK introduced the *Code of Best Practice*, which aimed primarily at increasing the accountability of directors to their shareholders and improving the transparency of corporate management of the listed firms. The code was a set of voluntary codes and guidelines regarding mainly the composition, responsibility, and accountability of the board of directors.

The SEHK set up the second and the third Working Group on Corporate Governance in 1994, which were mainly concerned with issues relating to executive and non-executive directors. Some guidelines were suggested as to the qualifications, appointments and roles for the independent non-executive directors. The SEHK required all listed member firms on the exchange to include a statement in their annual reports for periods ending December 31, 1995 and after, to affirm compliance with the *Code of Best Practice*. Where the firms had chosen not to comply with *the Code*, they would be required to provide reasons for non-compliance.

The fourth Working Group on Corporate Governance was formed in 1996. Its key tasks were to examine the role and legal liabilities of independent non-executive directors, audit committees, remuneration committees, and the education for directors. In view of the non-prevalence of audit committees among the listed firms at that time, the Working Group suggested that the formation of audit committees should not be made mandatory under the SEHK *Listing Rules*. Rather, it should be included in the *Code of Best Practice* as a recommended practice.

From 1995 to 2005, this working group, later known as the Corporate Governance Committee (CGC), compiled 8 reports recommending certain changes and providing guidelines in the corporate governance in Hong Kong, namely:

- (i) *First Report of the Working Group on Corporate Governance* (HKSA, 1995);
- (ii) *Second Report of the Corporate Governance Working Group* (HKSA, 1997a);
- (iii) *A Guide for the Formation of An Audit Committee* (HKSA, 1997b);
- (iv) *A Guide for Directors' Business Review in the Annual Report* (HKSA, 1998);
- (v) *Directors' Remuneration – Recommendations for Enhanced Transparency and Accountability* (HKSA, 1999);
- (vi) *Corporate Governance Disclosure in Annual Reports – A Guide to Current Requirements and Recommendations for Enhancement* (HKSA, 2001);
- (vii) *A Guide for Effective Audit Committees* (HKSA, 2002); and
- (viii) *Corporate Governance for Public Bodies: A Basic Framework* (2004).

Extensive consultation work with the listed firms, professional accounting bodies, regulatory bodies, and officials from overseas stock exchanges was carried out during the preparatory stages of these reports, resulting in substantive enrichment of the regulations. For instance, the *First Report* (1995) contained 19 recommendations for improved corporate governance standards and practices. The *Second Report* (1997), compiled based on a survey, revealed some contemporary disclosure shortcomings in the annual reports of listed firms with respect to the directors, shareholders rights, and audit committees. The CGC encountered some resistance from listed firms on how to meet with the requirements of forming an audit committee in 1997. As a result, it issued a *Guide for the Formation of audit Committee* (1997) and postponed the effective date for one year to allow sufficient time for the listed firms to form an audit committee.

Consultative papers and proposals were issued to all members of the SEHK soliciting their opinions and feedback before the recommendations were accepted and codified into the listing rules. The consultation period varied from 3 months to a full year, depending upon the extent of controversy of the issue. For example, the SEHK revised the *Code of Best Practice* in May 1998 by consolidating the recommendations suggested in the *First* and the *Second Report*, formally endorsing the guidelines on the formation of an audit committee. The adoption of the *Code* was voluntary. However, the *Listing Rules* would require all listed issuers to report in both interim reports and annual reports on their compliance with

the setting up of audit committees or the reasons for any non-compliance for accounting periods ending December 31, 1999 or after.

After the Enron, Worldcom, and Global Crossing debacles in early 2000s, the HKEx issued a circular *Consultation paper on proposed amendments to the listing rules relating to corporate governance issue* in 2002 to solicit opinions from the listed firms about the tightening of corporate governance practices. Subsequently, the HKEx published in January 2004 an exposure draft *Exposure of draft code on corporate governance practices and corporate governance report* to seek market views on the timing of the proposed implementation of the *Code on Corporate Governance Practices* (the *Code*), which aimed at formalising the disclosure of the listed firms' corporate governance practices in their annual reports.

In November 2004, the HKEx issued a 78-page report and announced that all listed firms on the HKEx would be required to comply with *the Code* for accounting periods commencing on or after January 1, 2005. All listed firms were required to release a separate Corporate Governance Report in accordance to the requirements as stipulated in *the Listing Rules* Appendix 14: Code on Corporate Governance Practices and Appendix 23: Corporate Governance Report.

Appendix 14 sets out the principles of good corporate governance and two levels of recommendations: (a) the code provisions; and (b) the recommended best practices. The areas covered in the principles of good corporate governance are as follows:

A. Directors:

Principles are issued on: 1) the Board; 2) Chairman and Executive Officer; 3) Board composition; 4) Appointments, re-election and removal; 5) Responsibilities of directors; and 6) Supply of and access to information.

B. Remuneration of Directors and Senior Management:

Principles are issued on the level and make-up of remuneration and disclosure.

C. Accountability and Audit:

Principles are issued on: 1) Financial reporting; 2) Internal controls; and 3) Audit Committee.

D. Delegation by the Board:

Principles are issued on: 1) Management Functions; and 2) Board Committees.

E. Communication with Shareholders:

Principles are issued on: 1) Effective communication; and 2) Voting by poll.

Appendix 23, on the other hand, prescribes the types of information to be disclosed in the Corporate Governance Report in terms of Mandatory Disclosure Requirements and Recommended Disclosures. The Mandatory Disclosure Requirements cover the following:

A. Corporate governance practices:

The issuer is expected to give 1) a narrative statement of how the listed issuer has applied the principles in the Code, providing explanation which enables its shareholders to evaluate how the principles have been applied; 2) a statement as to whether the issuer meets the code provisions in the Code. If the issuer has adopted its own code that exceeds the code provisions set out in the Code, the issuer may draw attention to such fact in its annual report; and 3) in the event of deviation from the code provisions set out in the Code, details of such deviation during the financial year with considered reasons for such deviation.

B. Directors' securities transactions:

The issuer is to state whether a code of conduct regarding directors' securities transactions as set out in Appendix 10 has been adopted or otherwise, and the details for the non-compliance.

C. Board of Directors:

The issuer has to provide details including composition of the board, number of meetings held, and individual attendance of each director. The issuer has to give a statement of how the board operates, including the type of decisions made by the board and those delegated to management. Details of non-compliance relating to the appointment of independent non-executive director and the remedial measures to address the non-compliance are expected. Relationship including financial, business, family or other material/relevant relationship(s) among members of the board and in particular, between the chairman and the chief executive officer.

D. Chairman and chief executive officer

The issuer is to state the identity of the chairman and chief executive officer, and whether the roles of the chairman and chief executive officer are segregated.

E. Non-executive directors

The issuer is to state the term of appointment of non-executive directors.

F. Remuneration of directors

The directors' remuneration policy have to be disclosed with respect to the role and function of the remuneration committee and its composition, the number of meeting held by the remuneration committee or the board of directors if there are no remuneration committee during the year. A summary of the work performed by the remuneration committee relating to the policy in determining executive directors' remuneration and the assessment of performance of executive directors have to be included.

G. Nomination of directors

The issuer is to spell out the role and function of the nomination committee, its composition, the nomination procedures and the process and criteria adopted by

the nomination committee. A summary of the work done by the nomination committee during the year and the number of meetings held are to be disclosed.

#### H. Auditors' remunerations

The issuer is to give an analysis of remuneration in respect of audit and non-audit services provided by the auditors to the issuer. Information about the entity that is under common control, ownership or management with the audit firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as part of the audit firm nationally or internationally.

#### I. Audit Committee

The issuer to give information about the role, function and composition of the committee members, the number of audit committee meetings held during the year with attendance record of members, report of the work performed by the audit committee during the year in discharging its responsibilities in its review of the quarterly (if relevant), half-yearly and annual results and system of internal control, and its other duties set out in the Code. Non-compliance of the audit committee and the steps to address such non-compliance has to be specified.

Despite such a corporate governance disclosure rule having been proclaimed, the HKEx remained flexible in implementing such requirements, as stated in Appendix 14:

“Issuers are expected to comply with, but may choose to deviate from, the code provisions. The recommended best practices are for guidance only. Issuers may also devise their own code on corporate governance practices on such terms as they may consider appropriate.”

(*Listing Rules*, HKEx 2005, Appendix 14, p. A14-1)

Where an issuer discloses according to the provisions of *the Code*, the disclosure will include the following:

- 1) An acknowledgement from the directors of their responsibility for preparing the accounts and a statement by the auditors about their reporting responsibilities.
- 2) A report on material uncertainties, if any, relating to events or conditions that may cast significant doubt upon the listed issuer's ability to continue as a going concern.
- 3) A statement that the board has conducted a review of the effectiveness of the system of internal control of the issuer and its subsidiaries; and
- 4) A statement from the audit committee explaining its recommendation and the reason(s) why the board has taken a different view from that of the audit committee regarding the selection, appointment, resignation or dismissal of the external auditors.

Issuer must state whether they have complied with the code provisions set out in this Code (i.e., Appendix 14) for the relevant accounting period in their interim reports and annual

reports. However, issuers are permitted *not* to comply with the recommended best practices in full provided that they explain the reasons why:

“In the case of the recommended best practices, issuers are encouraged, but are not required, to state whether they have complied with them and give considered reasons for any deviation.” (*Listing Rules*, HKEx 2005, p. A14-1)

Appendix 23 also sets out a list of recommended disclosure for the issuers’ reference. They are not mandatory but intended to be areas, which the issuers may comment on in their Corporate Governance Report. The areas include share interests of senior management, shareholders’ rights, investor relations, and internal controls and Management functions.

Due to the listed issuers’ inexperience and inadequate time to implement the internal control system, the part of the disclosure requirements on internal controls did not take effect for 6 months until July 2005. The requirements on Internal Control disclosure were then grouped under the Recommended Disclosures and not under the Mandatory Disclosure Requirements in Appendix 23. Subsequently, some listed firms opted not to disclose their internal controls mechanisms in their annual reports with fiscal year ending 2005.<sup>10</sup> It is worth noting that only 27% of the issuers on the Main Board and 39% of the issuers on Growth Enterprise Market had complied with the code provisions for the whole accounting period (i.e., January to December 2005), as shown in the review made by HKEx in their report of March 2007<sup>11</sup>. During the first year of implementation of *the Code*, there were variations in both the scope and the depth in their corporate governance disclosure (to be further discussed in Chapter 9: Descriptive Statistics). In effect, the disclosure by the listed firms in their fiscal year 2005 remained largely voluntary.

## 5.5 The institutional framework of Hong Kong’s securities and futures markets

The regulatory framework of Hong Kong’s securities and futures markets is mainly operated through three organisations: the Hong Kong Exchange (HKEx), the Securities and Futures Commission (SFC), and the Financial Reporting Council (FRC). From the legal perspective, the listed firms are subject to the Hong Kong Companies Ordinance (CO, Cap.

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<sup>10</sup> In its 2005 Annual Report, the HKEx disclosed that it had invited HKICPA to issue more guidance to help listed issuers to implement the CG Code requirements relating to internal control. It was also revealed that HKEx had organised regular CG training seminars and programmes to raise the listed issuers’ awareness of the good CG and the reporting standards. This reflects that some issuers were not complying with the mandatory disclosure requirements to the full within 2005, the first year in the *Code’s* implementation (HKEx, Corporate Governance Report, *Annual Report*, 2005).

<sup>11</sup> HKEx, *Analysis of Corporate Governance Practices Disclosure in 2005 Annual Report*, 2007, p. 2.

32) and the scrutiny of the listing rules of the Hong Kong Exchange on a continuous basis. The following is a brief discussion on these regulatory bodies and mechanisms.

### **5.5.1 The Hong Kong Exchange (HKEx)**

The Hong Kong Exchange (HKEx) is the only stock exchange in Hong Kong which provides facilities for the buying and selling of securities of listed companies in Hong Kong. It operates three markets: the Main Board Market, the Growth Enterprise Market (GEM), and the Trading-only Market. Each of them is discussed in turn below:

#### **1) Main Board Market**

In the Main Board Market, equity shares, warrants, debt securities, unit trusts and mutual funds, callable Bull/ Bear Contracts are traded. The HKEx provides facilities to enable buyers and sellers to trade their securities using the Third Generation Automated Order Matching and Execution System (AMS/3). The maximum number of outstanding orders per price queue is 20,000 in all trading sessions, which start from 10:00 a.m. to 4:00 p.m., Monday to Friday. The maximum size of an order in AMS/3 is 3,000 board lots, and that there is no restriction of outstanding orders per broker ID.

In 2003, 2004, and 2005, the total number of listed companies on the Main Board of the HKEx was 852, 892, and 934 respectively. By the end of 2007, there were 1,048 (975 in 2006) listed firms on the Main Board. Among them were 104 companies with 'H' shares (i.e., firms that are domiciled in mainland China with or without their own 'A' shares issued and traded in either one of the two stock exchanges in mainland China), and nine companies were foreign companies that were incorporated overseas and had a majority of business outside Hong Kong and China. The domestic equity market capitalization was HK\$ 20,698 billion (US\$bn 2,654.4), an increase of 55% over 2006. According to the World Federation of Exchanges, Hong Kong was the 7<sup>th</sup> largest stock market in the world<sup>12</sup> and the 3<sup>rd</sup> largest in Asia following Tokyo Stock Exchange (US\$bn 4,330.9) and Shanghai Stock Exchange (US\$b 3,694.3).

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<sup>12</sup> World Federation of Exchanges website:  
<http://www.world-exchanges.org/statistics/annual/2007/domestic-market-capitalization>

## 2) Growth Enterprise Market (GEM)

There were 193 listed companies on the GEM by the end of 2007 (198 in 2006). The total market capitalisation of GEM was HK\$bn 161.1 (HK\$bn 88.9 in 2006). The total turnover value on GEM in 2007 was HK\$bn 159.3, a 265% increase from 2006.

## 3) Trading-only market

There were two 'i'-Shares and seven NASDAQ stocks quoted on the trading-only market in 2007(same as 2006). Turnover was HK\$m 16.13 in 2007 (HK\$m 15.13 in 2006).

In respect of information disclosure, the listed companies on the HKEx are required to comply with the listing rules to make announcement to the public. The information announced includes, *inter alia*, company performance on a yearly basis. For the period of study of this thesis (2003-2005), listed companies were required to publish the company performance in Hong Kong newspapers. The HKEx ran a pilot scheme for six months from 25 June 2007 that, as long as a Main Board listed issuer published full announcement on its own website and the HKEx website with a notification of the announcement in the local newspapers, that issuer would not be obliged to make a paid announcement in the press. In addition, both Main Board and GEM listed issuers were required to submit their disclosures to HKEx electronically through the e-Submission System (ESS).

The pilot scheme was found to be successful and well accepted by the listed firms. Effective 25 December 2007, Main Board issuers publishing announcements on their own websites were no longer required to publish notifications in newspapers (source: *Fact Book 2007*, HKEx). The shift from the newspaper to the website should save the listed companies from incurring hefty costs in buying advertising space for publishing their full announcements in the press. On the other hand, publishing the announcements on company websites enables the public to acquire the information at any time. In this way, HKEx has encouraged the listed companies to provide easy access to the public for the company's information. During the period of study of this thesis (i.e., 2003 to 2005), the public still had to look out for the announcements of listed companies from newspapers, although there might be individual companies placing their announcements on their company website out of their initiative. The main source of information about the listed firms, especially the detailed disclosure of non-financial information, remained with the company annual reports.



### **5.5.2 The Securities and Futures Commission (SFC)**

The Securities and Future Commission (SFC) is the principal regulator of Hong Kong's securities and futures markets. It is an independent statutory body established in 1989 under the Securities and Futures Commission Ordinance (SFCO, Cap. 24), which was subsequently consolidated with nine other securities and futures related ordinances into the Securities and Futures Ordinance (SFO, Cap. 571) that came into operation effective 1 April 2003.

The primary function of the SFC is to administer the laws governing the securities and futures markets in Hong Kong. It is also responsible for the facilitation and encouraging the development of these markets. The regulatory objectives of the SFO are:

- 1) to maintain and promote the fairness, efficiency, competitiveness, transparency, and orderliness of the securities and futures industry;
- 2) to promote understanding by the public of the operation and functioning of the securities and futures industry;
- 3) to provide protection for members of the public investing in or holding financial products;
- 4) to minimise crime and misconduct in the securities and futures industry;
- 5) to reduce systemic risks in the securities and futures industry; and
- 6) to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry. (Source: Regulatory Framework and Rule, *Listing Rules 2005*, HKEx)

### **5.5.3 Financial Reporting Council (FRC)**

The Financial Reporting Council (FRC) is an independent statutory body responsible for investigating complaints concerning irregularities of auditors and reporting accounts, and non-compliance in the financial reports, of listed companies. It is funded jointly by the HKEx, the SFC, the Hong Kong Institute of Certified Public Accountants (HKICPA), and the Registrar of Companies.

The FRC has no authority to impose disciplinary action on, or prosecute, parties found to have breached any rules. In November and December 2007, the FRC entered into a Memoranda of Understanding (MOUs) with the SFC, the Hong Kong Monetary Authority (HKMA) and HKEx to facilitate information exchange and regulatory cooperation. This development implies that any irregularities in the financial reporting of the listed firms identified by the FRC can be brought to the attention of the three parties of the MOU, with

a view of making amendments to the legislations and practices, or taking disciplinary actions by the SFC if necessary.

The FRC was not operative for the period of study of this thesis from 2003 to 2005. It was only set up on 16 July 2007. The establishment of the FRC signals the intention of the regulatory bodies of Hong Kong to raise the corporate governance standards and improve the quality of disclosures in Hong Kong.

The above-mentioned discussion has summarized the historical development of the Hong Kong CG and regulatory framework. The following section, Section 5.6, will present the characteristics of Hong Kong stock market and the characteristics of Hong Kong listed firms.

## 5.6 Characteristics of Hong Kong stock market and Hong Kong listed firms

In this section, the characteristics of the Hong Kong stock market and Hong Kong listed firms are presented. These characteristics are either abstracted from the extant literature that has previously studied Hong Kong market and its listed firms, or sourced from the fact books of the HKEx and other regulatory organizations.

### 5.6.1 Characteristics of the Hong Kong Stock Market

Compared to other advanced economies such as the U.S., the U.K. and Australia, Hong Kong is “unique in its regulatory framework structure (relatively non-stringent financial reporting requirements) and corporate governance structure (most listed firms are family controlled)” (Ho, Lam & Sami, 2004, p. 384). Hong Kong is a market-driven economy with very few restrictions on the movement of capital. With very limited exception, there are no minimum local shareholding requirements or restrictions on foreign ownership of shares or assets.<sup>13</sup> For the 14<sup>th</sup> consecutive year in 2008, Hong Kong was ranked 1<sup>st</sup> out of 30 countries in the Asia-Pacific region by the Heritage Foundation in 2008 as the freest economy in the world.<sup>14</sup>

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<sup>13</sup> The exceptions being restrictions on the exercise of voting control by non-residents in respect of some types of licences in the broadcasting industry under certain circumstances, according to a Merges and Acquisitions booklet from the law firm Deacons:  
[http://www.deacons.com.hk/eng/knowledge/knowledge\\_106.htm#10](http://www.deacons.com.hk/eng/knowledge/knowledge_106.htm#10)

<sup>14</sup> 2008 *Index of Economic Freedom*, as per the Heritage Foundation website:  
<http://www.heritage.org/index/countries.cfm>

The rates of income tax and corporate tax in Hong Kong are very competitive, and overall taxation is relatively small as a percentage of GDP. Hong Kong does not recognise the concept of taxing capital gains on the disposal of assets, which include property and shares. There is no withholding tax payable in respect of distributions of dividends to shareholders. To the shareholders, dividend incomes are not subject to tax. Business regulation is simple. There are virtually no restrictions on foreign capital<sup>15</sup>. Not only does Hong Kong adopt an open-door policy on foreign capital movements, it is also one of the major players in the global financial markets. Hong Kong's stock market was the 6<sup>th</sup> largest in the world and the 2<sup>nd</sup> largest in Asia in terms of domestic market capitalisation in 2006.<sup>16</sup> As at end 2007, Hong Kong had a domestic market capitalisation of US\$bn 2,654, equivalent to 69% of that of the London Stock Exchange. In 2007, Hong Kong stock market ranked 7<sup>th</sup> in the world and was preceded by Shanghai stock market which experienced a phenomenal growth during the year.

The total market capitalisation in 2007 was HK\$bn 20,566.5 (US\$bn 2,636.7), an increase of 55% over 2006 (HK\$bn 13,248.8 or US\$bn 1,698.6). The average daily number of trade deals was 602,906 (255,596 deals in 2006). Main Board equities recorded a total turnover of HK\$bn 16,511.3 (US\$bn 2,116.8), risen by 157% when compared with 2006 in about the same number of trading days (246 trading days in 2007 and 247 days in 2006)<sup>17</sup>.

In sum, Hong Kong is an influential player in the global capital market. The HKSAR government, the HKEx, and the regulatory bodies recognise the importance of the stock market to the open economy of Hong Kong. They are determined to keep Hong Kong's pre-eminent position as a leading financial nexus in Asia and develop it as a world-class asset management centre. They accept that good corporate governance at market level and at company level is crucial to investors, and have taken continued efforts to foster CG culture, raise the CG standards, and improve the quality of disclosures in Hong Kong.<sup>18</sup>

The above section has discussed the characteristics of the overall Hong Kong stock market. The following section, Section 5.6.2, will describe the characteristics of Hong Kong listed firms.

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<sup>15</sup> See p. 205, *2008 Index of Economic Freedom*, The Heritage Foundation.

<sup>16</sup> World Federation of Exchanges:  
<http://www.worldexchanges.org/WFE/home.asp?menu=406&document=4140>

<sup>17</sup> HKEx *Fact Book 2007*.

<sup>18</sup> HKEx, *Annual Report*, 2005.

### 5.6.2 Characteristics of Hong Kong Listed Firms

Survey results show that firms in Hong Kong are historically characterised with a high concentration of family ownership. In a substantial number of firms in Hong Kong, individual shareholdings or family shareholdings far exceeded 10% (HKSA, 1997, p. 2-12). Concentrated ownership by families is not unique to Hong Kong firms. It is a common phenomenon in the East Asian region (Luo, 2007; Claessens, Djankov and Lang, 2000; Lim, 1981). Moreover, a substantial portion of board members of Hong Kong firms would belong to the management team or to the family that owned the firm (SEHK 1994, 1996). In fact, it is well documented in the accounting literature that family members tightly hold equity ownership in a typical Asian corporation (Claessens and Fang, 2002; Fan and Wong, 2002; Ho and Wong, 2001; Mok, Lam and Cheung, 1992).

What distinguishes Hong Kong family-owned firms from their counterparts in other Asian countries is that the business practices in Hong Kong have been heavily influenced by both the British value systems and the indigenous Chinese cultural values (Bond and King, 1985, p. 353-356). Hong Kong has been heavily influenced by the British accounting practices (Phenix, 1994, p.164-165). Even after the 1997 reunion with mainland China, it is still running the Anglo-Saxon common law legal framework, which encourages arms-length transactions in business dealings. At the same time, the social relations between constituent firms of a business conglomerate are predominantly family relations (Mok, Lam and Cheung, 1992; Lam, Mok, Cheung and Yam, 1994). Mok *et al* find that, out of the 77 largest corporations in Hong Kong between 1985 and 1989, 72 companies are identified as family-controlled by 36 different families. Of these 36 families, 15 families controlled a total of 51 companies, the market value of which totalled US\$43.34 billion, equivalent to 55.88% of Hong Kong's total market value, as of December 31, 1989 (*ibid*, 1992, p.282).

In Hong Kong, the family owners of publicly listed firms do not act merely as figure-heads of the firms but actively participate in the management of their corporations. In addition, the Chinese businessmen in Hong Kong extend their business control network by interlocking stock holdings (e.g., pyramiding) and interlocking directorships. Firms with ownership by a particular family are recognized as a group by the market. Those groups of family-owned firms, particularly those owned by Chinese businessmen, tend to have family members appointed to the board of directors, or holding key executive positions in the firms. Pennings (1980) suggests that a tight network of interlocking directorates can enhance a group's survival. Firms involved in interlocking directorates may help each

other in business dealings, thus creating resource interdependence in sharing business expertise and knowledge, adopting similar accounting policies, applying common corporate governance values and practices, and appointing alike financial reporting services (e.g., external auditors and tax consultants). In short, family-owned firms of the same group have the advantage over non-family owned firms competing in the same market economy in that the former ones can share the information set among the group.

The concentration of family ownership has an impact on the stock price performance of listed firms in Hong Kong. Empirical studies have shown that prices of constituent stocks controlled by a family tend to move together more than prices of stocks controlled by different families (Mok, Lam and Cheung, 1992, 1989). The within-family-group correlation coefficients are much larger than the between-family-group correlation coefficients, indicating that firms in the family grouping are homogeneous. It seems to suggest that firms belonging to the same homogeneous group tend to co-vary more strongly within the family group than within industry groups.

Mok *et al* (1992) also find that, whereas family association is significant in explaining returns covariation among the Chinese family groups of firm, the relationship is not significant for the non-Chinese family groups. Such a difference may be attributed to the characteristics of the non-Chinese family groups, which have more diversified business and there is only one family member sitting on the Board of Directors with the other directors being mostly professional management personnel. On the contrary, the Chinese family groups usually have family members as chairmen of the Board of Directors or holding significant executive positions.

There is less incentive for transparency in respect of firms in the East Asian countries, including Hong Kong, as compared to the Anglo-American firms due to differences in cultural environments (Ball, Wu and Robin, 1999, p.3), as quoted in the study by Chen and Jaggi (2000). Chen and Jaggi find significant variations in financial disclosures across 87 large Hong Kong firms. The comprehensiveness of disclosures increases with the increase in the proportion of independent non-executive directors (INEDs). However, for family-controlled firms in Hong Kong, the impact of INED on financial disclosure is relatively weaker than non-family controlled firms (*ibid*, 2000). Under this circumstance, it remains an empirical issue to test whether an enhanced level of requirements in corporate governance disclosure, in similar fashion to the enhanced requirements of financial

disclosure, would have an impact on a firm's valuation. Before any empirical tests are proposed, the setting of this study is explained in the following section.

### **5.6.3 The setting for the current study**

Hong Kong has a common law regime. Being a former British colony, Hong Kong has its legal origin transplanted from the U.K. All business transactions, commercial contracts, and trading activities are under the jurisdiction of common law courts. Researchers have generally regarded the common law jurisdiction in Hong Kong as an important factor in providing high quality financial reporting (Ball, Robin, and Wu, 2003)<sup>19</sup>, high judicial efficiency (Johnson, Boone, Breach, and Friedman, 2000), and high level of investor protection (LLSV, 2002). The presence of many multi-national corporations, and the Anglo-American accounting practices hitherto developed and adopted in Hong Kong require more information disclosure and emphasize transparency on the firms' owners and managers.

Hong Kong has always been an open economy. Hong Kong relies heavily on international trading. It is currently the world's 12<sup>th</sup> largest trading entity. In 2007, its visible trade (including re-export, domestic exports and imports of goods) reached HK\$ 5, 551 billion, equivalent to 343% of GDP, as compared to 223% (in 1997) and 190% (in 1987) in previous decades<sup>20</sup> (Hong Kong Yearbook, 2007, p. 41). The openness of Hong Kong economy is further evidenced by the pegging of its currency with the U.S. dollars since 1983; and the link has since not been waived even after Hong Kong's political reunion with China in 1997. According to Stulz and Williamson's (2003) model, an open economy is negatively correlated to the shareholder's rights but positively correlated to creditor's rights. Stronger creditor protection demands more transparency, which is backed up by a common law court system. Culturally, Hong Kong remains essentially a Chinese society which is less inclined to much voluntary disclosure. The combination of these characteristics makes Hong Kong an ideal place for researchers to investigate which factor(s) of CG are important to the investors and to what extent each factor affects the overall protection of the minority outsiders from the expropriation by the insiders.

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<sup>19</sup> Ball *et al* address quality as "the extent to which accounting information reflects the underlying economic situation of the firm" and is related to the concept of transparency, which is defined as "the ability of users to 'see through' the financial statements to comprehend the underlying accounting events and transactions in the firm" (*ibid*, 2003, p. 237).

<sup>20</sup> If the value of exports and imports of services is also taken into account, the proportion of GDP would be even greater: 404% (in 2007), 259% (in 1997) and 230% (in 1987). Sources: *Hong Kong Yearbook 2007*, the Government of Hong Kong Special Administrative Region (HKSAR).

Hong Kong is characterised with a highly concentrated ownership in business by families. Researchers have found that firms in the same family group have advantages over other non-family firms in terms of information sharing. However, family-owned firms tend to present entrenchment problems that will not be beneficial in attracting investments. Disclosure, on the other hand, helps eliminating the concerns from investors. Hong Kong provides a unique environment to examine empirically firm characteristics that can affect corporate governance disclosure in a setting of highly family concentrated ownership.

The establishment of the corporate governance framework by HKEx for its listed firms to take effect in the fiscal year of 2005 provides a good opportunity to investigate the effect of voluntary disclosure of corporate governance practices of listed firms in Hong Kong with respect to a firm's value. In studying the data for the three years from 2002-2005 when disclosure of corporate governance information was not yet strictly enforced by HKEx, the relationship between voluntary disclosure of corporate governance practices of listed firms in Hong Kong with respect to a firm's value can be revealed.

In addition, the listed firms in Hong Kong had been years ahead aware of the imminent corporate governance disclosure requirements that were to take effect soon (i.e., since the SCCLR consultation paper 2001). The disclosure that some firms had voluntarily carried out prior to 2005 would be a valid indicator as to which firms were *willing* to comply with the disclosure requirements ahead of others. Moreover, the *comprehensiveness* of such voluntary disclosure would also differentiate some early compliance firms from the late conformers about their commitments to a better *quality* of corporate governance. Such voluntary corporate disclosure will therefore be used and seen as a signal to the market to differentiate the 'good' firms from the 'bad' firms in terms of corporate governance. If investors can interpret such signal correctly, the market is expected to respond which should give rise to variations in the firms' market valuation, *ceteris paribus*.

In this study, the comprehensiveness of the voluntary corporate governance disclosure of Hong Kong firms from 2003 to 2005 is measured by a composite score CGDscore, based on the requirements as suggested by the Appendix 23 of the HKEx *Listing Rules*. Empirical tests are then carried out to see if such level of voluntary disclosure has any impact on the firms' valuation, controlling for the firm-specific characteristics. Also, this study will examine whether the outside investors would employ dividend payout as a

mitigating factor to determine the firm's value, given the state of corporate governance disclosed in most family-owned firms in Hong Kong.

## 5.7 Summary

This chapter summarizes the historical development of corporate governance requirements of Hong Kong firms. It also presents the general legal and financial reporting framework and identifies the major institutional players within the regulatory framework of Hong Kong. Being an international financial centre in Asia, Hong Kong differs from other Asian Pacific economies in that it exhibits both the Anglo-Saxon type of open market characteristics and the conventional type of Chinese family-orientation in ownership plus control in corporations. The legacy of the British rule after 1997 is still prevalent in business, accounting, financial and legal regimes. The government officials of the Hong Kong Special Administrative Region (HKSAR) have been vigilant in making the stock market more transparent and fairer to all investors<sup>21</sup>, local or overseas, in order to upkeep and further promote Hong Kong as a financial centre (being the 2<sup>nd</sup> largest in Asia outside Japan).

On the other hand, the cultural environment in which Hong Kong firms operate (being dominated by Chinese people) does not encourage voluntary disclosure of corporate information (Chau and Gray, 2002; Chow, Chau and Gray, 1995). The influence of conservatism and tendency to secrecy of Chinese family-controlled firms, the growing demand for transparency, and the desire for internationalisation of the market jointly make Hong Kong the ideal setting for empirically examining how firms behave in corporate governance disclosure within an open economy and the impact, if any, of such voluntary disclosure on firm's valuation. The next chapter, Chapter 6, presents the hypotheses to be tested in this study, while Chapter 7 describes the variables to be used for testing those hypotheses. Chapter 8 expounds the sample selection and research design.

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<sup>21</sup> Speech by the Secretary for Financial Services and the Treasury Branch (FSTB), HKSAR, September 2003.



# Chapter 6: Development of Hypotheses

## 6.1 Introduction

The relationship between the disclosure of firms and their market valuation has been the subject of investigation by many corporate governance researchers since the late 1990s. Most of their works are cross-country studies, focusing on the differences in firms' performances in different economies under various legal environments. The selected sample firms in those studies are very often large in size but small in number for each country (e.g., LLSV, 1998; Mitton, 2002; Klapper and Love, 2004; Daouk, Lee, and Ng, 2006). The results of the governance-valuation relationship tested in these studies, though valid, are based on large-capitalized firms. They may not be applicable for relatively small firms.

This study differs from other studies in that it aims at investigating corporate governance (CG) disclosure of large firms (LargeCap), medium firms (MidCap), and small firms (SmallCap) within one economy – Hong Kong – where minority shareholders' rights are protected by a strong legal regime but a predominant share ownership (i.e., more than 50%) also prevails. High concentration of ownership implies that the classic agency problem stemming from the separation of ownership (shareholders) and control (managers) is less severe than entrenchment (Fan and Wong, 2002; Cheung, Connelly, Limpaphayom and Zhou, 2007). One of the objectives of this study is to investigate whether the relationship between voluntary CG disclosure and firm valuation, if any, would vary for different market-capitalisation firms, when the classic agency problem arising from the separation of ownership and control (Jensen and Meckling, 1976) is rarely observed.

This chapter presents the hypotheses tested in this thesis in light of the literature that has been reviewed in the previous chapters. It also discusses the rationale of the hypotheses in relation to other firm-specific variables.

## 6.2 Research questions

Evidence from prior studies summarised previously in Chapter 3 and Chapter 4 suggests that voluntary disclosure of a firm's corporate governance (CG) is useful in reducing the information asymmetry between the insiders and the outsiders of a firm. More disclosure can increase investor awareness of the firm, hence reduce the cost of capital and increase equity valuation (Berglof and Pajuste, 2005). The information set available to outside investors can be drastically different for firms of different sizes and complexity, though. Many research studies have shown an inverse relation between information content and firm size (Atiase, 1985; Freeman, 1987, Bhushan, 1989a). These studies argue that larger firms are followed by more analysts, resulting in greater private information acquisition about those large firms. They posit that analysts have incentives to focus on large firms rather than small firms because the former are more widely held. Large firms stimulate the interest of a larger number of investors with more potential transactions business. Therefore, the larger is the firm size, the more opportunities that will lead to more transactions business for the analysts (Bhushan, 1989a).

Other factors affecting the information set (hence the information asymmetry between insiders and outsiders) of large firms and small firms include listing age, firm reputation, and the costs of securing a controlling share ownership. Large firms usually grow from small firms. Compared with the small firms, they tend to have a longer listing history and may often enjoy a market reputation, a competitive power, and a degree of resourcefulness that are beyond the reach of the small firms.

Ownership structure amongst large, medium, and small firms is often different. In large firms, ownership tends to be more dispersed than smaller firms as it requires much more cash outlay to procure a controlling (i.e., more than 50%) portion of equity ownership of a large firm than for the same percentage of a small firm.<sup>1</sup> For example, Faccio and Lang (2002) report a firm size effect on ownership. In their empirical study of 5,232 firms in 13 Western countries from 1996 to 1999, they find that large firms are more likely to be widely held than small firms. In the U.K., Faccio and Lang observe that 90% of large

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<sup>1</sup> Bennedsen and Wolfenzon (2000) demonstrate in a model that, under a one-share-one-vote ownership structure, a winning coalition of shareholders is formed with more than 50% of the cash flow rights. However, in order to achieve absolute control of a firm, the optimal level of ownership for one investor is to buy more than two-thirds of the cash flow rights. The optimal investor would have to be very wealthy in the case of a large firm.

firms are widely held at the 20% voting rights threshold, but only 14% of small firms are widely held at the 10% voting rights threshold.

On the other hand, most small listed firms tend to be younger in terms of listing age. They may have obtained their listing status relatively recently. The management style, business philosophy, and business model of small firms may not be all too familiar to potential investors. Financial analysts may not be interested in following these relatively un-established, small, firms either, as it would not be economical for them to track, identify, and follow the business strategies and evaluate the potentials of those small firms which are often not transparent in their company disclosure.

In terms of information set, more importantly is that corporate transparency has been directly linked to corporate governance (Gul and Leung, 2004). Investors want governance that is designed and administered to protect the interest of all shareholders (Berardino, 2001). Without analyst following and in the absence of voluntary disclosure by the firm, the information gap between insiders and outsiders for small firms may be much greater than that for the large/ medium firms. Outsiders may consider it risky to invest into small firms if there is insufficient information about the management, the sustainability, and the growth potential of small firms. Thus, investors (and potential investors) are expected to discount the share price when disclosure is inadequate (Leung and Horwitz, 2004).

In view of such differences in information sets available to potential investors regarding large and small firms, it is therefore justifiable to analyse the voluntary CG disclosure behaviour of the firms separately according to their firm size grouping. In this study, the sample firms are chosen according the Hang Seng Hong Kong Composite Index (HSKCI), which is sub-classified by size into the Hang Seng HK LargeCap Index, Hang Seng HK MidCap Index, and Hang Seng HK SmallCap Index. A brief description about the classification criteria is summarized below (detailed descriptions of the firms will be presented in Chapter 8)<sup>2</sup>.

The Hang Seng Hong Kong Composite Index (HSKCI) is part of the Hang Seng Composite Index (HSCI) series. The HSCI aims to provide a comprehensive benchmark of the performance of stocks in the Hong Kong stock market and comprises the top 200 companies listed on the Hong Kong Exchange (HKEx). The series covers about 90% of the

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<sup>2</sup> Source: *Brochure: Hang Seng Composite Index Series, Hang Seng Freefloat Index Series, Hang Seng Index* (<http://www.hsi.com>).

total market capitalisation of all stocks listed on the Main Board. The HSCI series is divided into Geographical Indices and Industry Indices. If the HSCI constituent companies with over 50% of their sales revenue (or profits, or assets if more appropriate) are derived from mainland China, they are included in the Hang Seng Mainland Composite Index (HSMLCI). Companies not included in the HSMLCI, where sales revenue is derived from Hong Kong and outside the mainland China, are then included in the Hang Seng Hong Kong Composite Index (HSHKCI).

The HSHKCI is further sub-divided into three indices based on the size of the constituents, namely, the Hang Seng HK LargeCap Index (HSHKLI), the Hang Seng MidCap Index (HSHKMI), and the Hang Seng HK SmallCap Index (HSHKSI). The first index (HSHKLI) covers the largest 15 constituent stocks, whose market performance are reviewed regularly by Hang Seng Index Company, the company that prepares these index series. Any stock with a market capitalisation ranking that falls below 18th position in the HSHKCI will be removed from the HSHKLI, while any stock ranking above 12th position will be included. The HSHKLI covers about 80% of the market capitalisation of the HSHKCI.

The second index (HSHKMI) covers the Midcap firms. It comprises 35 constituent stocks and covers the next 15% of the market capitalisation of the HSHKCI, following the top 80%. In regular reviews, any stock with a market capitalisation ranking that falls below the 60th position in the HSHKCI will be removed from the HSHKMI, while any stock ranking above 40th position will be included. Finally, the SmallCap index (HSHKSI) includes the remaining stocks of the HSHKCI which are not included in the HSHKLI or the HSHKMI. It covers the remaining 5% of the market capitalisation of the HSHKCI.

It should be pointed out that a firm's market capitalization is a continuous variable that may lie anywhere along a continuum of values. The classification methodology of LargeCap, MidCap, and SmallCap firms by the Hang Seng Index Company is arbitrary. There is no hard and fast rule that explains why large firms must be confined to the largest 15 firms only. Nor is there any economic theory to justify that firms of medium size can only comprise those ranking between 16<sup>th</sup> and the 59<sup>th</sup> largest market capitalization. Like any index classification methodology, the classification of firms by market capitalization is a matter of common practice if not a matter of convenience. This study follows the classification of Hang Seng Hong Kong Composite Index in grouping the Hong Kong

listed firms under study into large (LargeCap), medium (MidCap) and small (SmallCap) firms.

There are four basic research questions in this study, which will be applied to LargeCap, MidCap, and SmallCap firms separately as individual groups first and then jointly as a pooled sample. They are discussed in turn below.

### **Research question 1**

The first research question investigated in this study is whether voluntary disclosure of corporate governance (CG) affects a firm's valuation. The importance of this question lies in the fact that voluntary disclosure is an act of signalling from insiders to outsiders. As Verrecchia (1983) puts it, "The manager decides to either release or withhold this signal on the basis of the information's effect on the asset's market price" (*ibid*, 1983, p.179). Yet, strictly speaking, signalling on CG provides no additional information about the financial prospects or future cash flow of a firm. Will such signalling on CG be recognised as credible information about the firm? Will the market appreciate such non-financial disclosure by the firm and respond by according a higher market valuation to the firm?

### **Research question 2**

When a predominant shareholder is present, it is questionable that firms will keep on voluntarily disclosing their CG. One could argue that the predominant shareholder is unrivalled in decision-making contests in the board of directors; there is no point in disclosing CG information to the minority outsiders. On the other hand, one could also argue that the minority outsiders are concerned about potential expropriation by the majority shareholder, derived from the majority shareholder's dominant position in the equity holding. To alleviate some of these concerns, the majority shareholder may choose to voluntarily disclose more information on the CG practices, or voluntarily commit to a higher CG standard.

Therefore, the second research question in this thesis is: Does concentrated ownership structure have any effect on the level of voluntary disclosure of CG? What are the other CG variables that may also influence the level of voluntary disclosure? The empirical findings for this research question can shed light on the effect of concentrated ownership structure on the level of voluntary disclosure of CG.

### **Research question 3**

Doidge, Karolyi, and Stulz (2007) posit that the most important benefit that good governance brings to a firm is the access to capital markets on better terms. Compared with LargeCap firms, SmallCap firms can be expected to have more difficulty in obtaining their capital on better terms. When SmallCap firms have bigger potential for business growth, their needs to tap the capital market will lead to stronger incentives to disclose voluntarily. In that case, will there be systematic differences in the voluntary CG disclosure between the LargeCap firms, MidCap firms, and SmallCap firms? If there are systematic differences in disclosure amongst the groups, will the different levels of disclosure affect their firm valuation, *ceteris paribus*? To what extent do LargeCap firms, MidCap firms, and SmallCap firms behave differently in terms of voluntary disclosure of CG? These are the areas of inquiry for the third research question of this study.

### **Research question 4**

For firms with a predominant shareholder, the minority outside investors would be legally powerless to remove incompetent management. Moreover, both the market valuation and dividend payout tend to be lower (Morck, Shleifer, and Vishny, 1988). Morck *et al* posit that the quality of CG not only affects a firm's access to and the amount of external financing but also the cost of capital and firm valuation. Outsiders are less willing to provide financing to a firm with poor CG. As a result, they are more likely to demand a higher rate if the rate of return is seen as more risky, due to poor CG. Claessens (2006) argues that conflicts between small and large controlling shareholders are greater in weaker CG environments, which implies that smaller investors receive lower rates of return, in terms of either dividend payout or capital gains. Would voluntary CG disclosure and dividend payout of firms with prominent shareholder be any different from for firms without a dominant shareholder? If voluntary disclosure is a signalling device for sound management, can more voluntary disclosure of CG be a substitute for dividends to the small investors? These are the issues to be addressed in the fourth research question of this study.

The following section, Section 6.3, will discuss the development of these research questions into testable hypotheses, using Hong Kong listed firms as samples. The rationale for using Hong Kong listed firms as samples is provided and further discussed in Section 8.2 of Chapter 8.

## 6.3 Hypotheses development

In this section, testable hypotheses will be developed with justifications provided. Much of the supporting arguments are derived from the literature review sections previously discussed in Chapters 3 and 4. To facilitate the reasoning of these arguments for testable hypotheses in this study, the abstracts of main findings from prior key literature are re-presented in the following subsections. They are presented to lend support to the building up of the hypotheses.

Research Question 1, which is mainly on the value relevancy of voluntary CG disclosure, is addressed in Section 6.3.1 where the arguments for Hypothesis 1 (H1) are expounded. In Section 6.3.2, Research Question 2 is analysed and developed into 5 hypotheses (i.e., H2a - H2e) which aim at testing the factors that affect voluntary CG disclosure under concentrated ownership. The arguments for selecting the control variables are also presented in that section. Section 6.3.3 deals with Research Question 3, which queries the systematic differences among various firms' capitalization. Five hypotheses (i.e., H3a – H3e) are developed. Research Question 4, which explores the use of dividends as means of enhanced investor protection, is expounded in two sections. Section 6.3.4 presents the hypothesis (H4), which tests the linkage between voluntary CG disclosure with dividend payout. Section 6.3.5 explicates the hypothesis (H5) why dividend payout is also jointly affected by the level of insider ownership and the voluntary CG disclosure of a firm. A summary of this chapter is presented in Section 6.4.

### 6.3.1 Voluntary CG disclosure and valuation

As argued by Jensen and Meckling (1976), agency problem may not be a major problem if the interests of managers are aligned with the owners of a firm. This would be the case when the firm is tightly owned and controlled by a family and the CEO is also the controlling owner, as is the case in most of the firms in Hong Kong. However, the entrenchment of managers may become a problem because minority shareholders are legally powerless to remove the controlling directors. There is a possibility for the problem to occur within a high investor protection regime such as Hong Kong (where the Anglo-Saxon common law system is maintained and practised after the re-union with China in 1997).

In cases of severe agency problem of entrenchment, outside investors can be expected to be reluctant to invest in a firm, which does not implement good corporate governance, especially if there is a *track record* of expropriation of minority shareholders, or there is any *sign* of potential expropriation, by the majority shareholder. Investors will therefore “discount stocks according to perceived corporate governance issues” (Claessens and Fan 2002, p. 95). It can therefore be argued that investors will not pay as high a price for the stock of a firm suspicious of questionable corporate governance. It follows that, *a priori*, firms that exhibit poor corporate governance should exhibit a lower market value, *ceteris paribus*, than other firms similar in size, scale, nature, or other firm characteristics under the same legal protection regime.

On the other hand, firms with good corporate governance practices would have the incentive to differentiate themselves from firms with poor corporate governance because better corporate governance can benefit firms in many ways (Claessens, 2006). These include:

- 1) Increased access to external financing which can lead to greater investment, higher growth, and more employment creation;
- 2) Lower cost of capital and associated higher firm valuation, which makes more investments attractive to investors and leads to growth and employment;
- 3) Better operational performance, through better allocation of resources and better management, which creates wealth;
- 4) Reduced risk of financial crises, as financial crises (e.g., the 1997 Asian crisis) can impose large economic and social costs;
- 5) Better relationships with all stakeholders, which helps improve social and labour relationships and areas such as environmental protection (*ibid*, 2006, p. 99).

The argument that firms with better corporate governance tend to disclose more about their corporate governance structure and practices stems directly from the signalling theory of voluntary disclosure (Ross, 1979; Milgrom, 1982; Verrecchia, 1983; Dye, 1985; Lev and Penman, 1990). In Ross’s model and Milgrom’s theoretical information asymmetry model between the agent and principal, the agent always has a choice of an optimal act to signal to the principal. Implicit in such signalling models is that their analysis is driven by a monotonicity property: more good news about the state of affairs in a firm would lead to a favourable revision of a firm’s market valuation. In a rational expectations model, it is accepted that “the arrival of good news about a firm’s prospects would cause the price of its stock to rise” (Milgrom, 1982, p.381). One implication is that individual pieces of



information can be ordered by favourableness. For example, in a securities market model, *more favourable* news about a security's future returns leads to a *higher price* for that security. The agent would therefore select the *most favourable* information to release first in order to achieve the best potential impact on a firm's valuation.

Voluntary disclosure literature follows the same argument which suggests that, given a choice to disclose, at equilibrium, the interested party will report the information that is most favourable to its case, while withholding less favourable information. It can be argued that voluntary disclosure is a special case of game theory. The central premise of such an argument is that an entity contemplating a voluntary disclosure "will disclose information that is favourable to the entity, and will not disclose information unfavourable to the entity" (Dye, 2001, p.184). The significance of the voluntary disclosure theory therefore lies in the *intention* and the *expected reactions* to such voluntary act of disclosure (Dye, 1985). Dye's disclosure principle argues that those insiders (i.e., managers) with information to imply the firm is undervalued by the market will disclose it credibly such that their firm's stock price will be revised upward. Similarly, those managers with information that implies values below market will withhold rather than disclose such information for as long as they can until it is legally necessary to disclose it.

One implication of the voluntary disclosure theory is that: investors will perceive those non-disclosing firms (also known as "silent firms") as firms with less than average valuation. Accordingly, the prices of their shares will be re-valued downwards<sup>3</sup>. This potential downward price revision of non-disclosing firms will, in turn, motivate those firms with relatively good news to screen themselves out of the same group by disclosing their information. The disclosure process will therefore self-sustain until the positions of all firms in the valuation hierarchy are identified (Lev and Penman, 1990, p. 49).

Since voluntary disclosure can benefit the investors and the firms in terms of liquidity and a lower cost of capital (Diamond and Verrecchia, 1991; Baiman and Verrecchia, 1996, and others as reviewed in Section 4.3), firms with good corporate governance have strong incentives to differentiate themselves from the not-so-good corporate governance firms. Good CG firms would endeavour to communicate to the outside investors that they are

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<sup>3</sup> The classic "lemons" model by Akerlof (1970) points out that, taking used cars as an analogy, the good cars may be driven out of the market by the lemons if no proper, credible, signalling device is available to the buyers and sellers. "For it is quite possible to have the bad driving out the not-so-bad driving out the medium driving out the not-so-good driving out the good in such a sequence of events that no market exists at all." (Akerlof, 1970, p. 490)

practising a higher quality of corporate governance than others. There are arguably several ways to achieve this objective:

- (i) adopt more corporate governance *structures and practices* than is recommended by the regulatory bodies;
- (ii) disclose more in-depth the corporate governance (i.e., the quality of corporate governance) being implemented within the firm on a *voluntary* basis; or
- (iii) apply, implement, and disclose more corporate governance practices *earlier* than is statutorily required by the regulatory bodies.

Leuz and Verrecchia (2000) posit that information asymmetries between the firm and its shareholders will create costs by introducing adverse selection into transactions between buyers and sellers of a firm's shares. Adverse selection often leads to a lower liquidity of firm shares. To overcome the reluctance of potential investors to buy or hold such firms' shares, firms have to issue capital at a discounted price. Discounted price results in fewer proceeds to the firms and hence higher costs of capital. Leuz and Verrecchia thus argue that a *commitment* to increased levels of disclosure will reduce the possibility of information asymmetries. This in turn should reduce the discount at which firms' shares are sold, and hence lower the costs of issuing capital (*ibid*, 2000, p.92).

It follows from this argument that firms that are better governed will disclose more about their corporate governance practices to differentiate them from others. Based on such voluntary disclosure, investors are willing to pay a premium for their shares. In view of the forgone discussion, Hypothesis 1 (stated in the alternative form), which is investigated in this study, postulates that<sup>4</sup>:

Hypothesis 1(H<sub>1</sub>)

H<sub>1</sub>: Firms that voluntarily disclose more information with regard to their corporate governance practices have higher market valuation than firms that disclose less, *ceteris paribus*.

The variables to be employed in hypothesis H<sub>1</sub> will be:

- the market valuation (as proxied by Tobin's q or the Market-to-book ratio); and
- the corporate governance disclosure score.

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<sup>4</sup> For those firms with poorer governance, it may be argued that they may also employ a "me-too" strategy in disclosing their CG practices. They may "talk cheap" and yet decline to practise what they preach in their annual reports about the state of their CG. While there is no effective means to guard against such malpractices, there is, nevertheless, a reputation cost involved. If the firms do not intend to improve their CG, then they stand to lose their credibility if what they *voluntarily* disclose do not match what they are practising. This is especially the case when they have no obligation at all to disclose their CG in the first place during the pre-regulation years.

In this study, the firms' market valuation is appraised by an approximation of Tobin's  $q$ . The original Tobin's  $q$  (Brainard and Tobin, 1968; Tobin and Brainard, 1977; Tobin, 1969, 1978; Lindenberg and Ross, 1981) is a financial market-based measure of firm performance defined as the present value of future cash flows divided by the replacement cost of tangible assets. However, Chung and Pruitt (1994) have developed a simple approximation of Tobin's  $q$ . This measure of market valuation has been widely used in recent CG and firm valuation studies such as: Black, Jang, and Kim (2006); Durnev and Kim (2005); Cremers and Nair (2005); Gompers, Ishii, and Metrick (2003); Kaplan and Zingales (1997); Lang and Stulz (1994); McConnell and Servaes (1990); Morck, Shleifer, and Vishny (1988), Lindenberg and Ross (1981), among other extant researchers. Further discussion of the definition of the approximation of Tobin's  $q$  is presented in Chapter 7.

To capture the level of disclosure, a measurement needs to be devised. The corporate governance disclosure requirements are detailed in the HKEx Listing Rule Appendix 23. Based on this Appendix, a checklist containing the items required for disclosure is compiled. By comparing a firm's disclosure as revealed in its annual reports from 2003 to 2005 against the checklist, a Corporate Governance Disclosure score (CGDscore) is computed to indicate the level of disclosure of individual firms. More elaboration on the compilation of such a CGDscore and the choice of metric for market valuation will be presented in Chapter 8: Methodology.

### **6.3.2 Factors affecting voluntary CG disclosure**

The second Research Question investigates if there are other firm characteristics affecting the voluntary CG disclosures of firms, which can be formulated into a testable hypothesis as follows:

#### **Hypothesis 2 (H2)**

H2: The level of voluntary CG disclosure is influenced by the CG practices within the firm and the level of insiders' ownership, controlling for the firm's performance and capital structure.

This hypothesis is of particular interest as there is a prevalence of a predominant or controlling shareholder across all sizes of firms that it has included as samples, while most research studies investigate the disclosure-firm characteristics relationship based on U.S. and U.K companies where ownership is diverse (see Chapter 3). Extant research studies have identified the following factors as related to the level of CG disclosure:

### i) Ownership structure

Previous CG disclosure research suggests that the voluntary disclosure level is associated with concentration of ownership of a firm (Berglof and Pajuste, 2005; Eng and Mak, 2003). Based on a sample of 370 non-financial firms listed on 10 Central and Eastern European stock exchanges, Berglof and Pajuste find that a more concentrated ownership is significantly and *negatively* associated with the disclosure level. They find empirical evidence that firms with more concentrated ownership structures disclose less. They argue that controlling shareholders disclose less in order to enjoy more benefits that are private. Their view supports Eng and Mak (2003) who find that lower managerial ownership are associated with increased disclosure, but total block-holder ownership is not related to disclosure for Singapore firms. Hence, a sub-hypothesis can be postulated as follows:

### Hypothesis 2a

H2a: A firm's voluntary CG disclosure is negatively related to the insiders' ownership (proxied by the directors' equity shareholding as a percentage of total outstanding shares).

### ii) Independent Non-Executive Directors

Berglof and Pajuste (2005) endorse the view proposed by Ostberg (2004) that disclosure is essentially a form of minority protection that reduces the scope for extraction of private benefits by controlling shareholders. Fama and Jensen (1983b) have argued that the presence of Independent Non-Executive Directors (INEDs) is an important vehicle to reduce the expropriation risk and enhance minority investor protection. The presence of INEDs is an internal mechanism to safeguard investors from undue expropriation by an unchecked, predominant, shareholder. Weisbach (1988) finds boards of directors dominated by INEDs play a significant role in adding firm value through CEO changes. The numbers of INEDs sitting on the board and the INEDs as a percentage of the board are commonly regarded as indicators of how much a Chairman/CEO's power is being monitored by the outside directors (Weisbach, 1988). Jensen (1993) proposes INEDs should dominate the board. He even goes to the extreme as to suggest that "the only inside board member should be the CEO" (Jensen, 1993, p. 865).

Even if under certain circumstances that they are powerless to constrain the CEO/Chairman's predominance on the board, INEDs are considered as useful in influencing the CEO/Chairman's deliberations and decisions (Pearce and Zahra, 1992). Likewise, Mayers, Shivdasani and Smith (1997) show that INEDs perform an important monitoring function within the firm (see Chapter 2: Literature Review, Section 2.4.2).

Therefore, a positive relationship is expected to exist between the number of INEDs and the control and monitoring of the insiders' responsibilities, which include the dissemination of information to the outsiders.

Indeed, Patelli and Prencipe (2007) provide empirical evidence that there is a positive correlation between the proportion of INEDs on the board and the amount of voluntary information disclosed by the firms in their annual reports. Such correlation is found after controlling for ownership, size, leverage, profitability, and labour pressure. Their empirical evidence is consistent with the expectation that, with more outsiders sitting on the board, insiders are more willing to disclose information that allows for a better understanding of their current performance, rather than the information concerning the past or future expected results. Patelli and Prencipe's empirical results reinforce the notion that voluntary disclosure is significantly influenced by the proportion of INEDs, the firm's size, and ownership diffusion. Hence, it can be hypothesized that:

Hypothesis 2b

H2b: A firm's voluntary CG disclosure is positively related to the number of INEDs and the percentage of INEDs sitting on the board, *ceteris paribus*.

iii) Firm resourcefulness

According to Berglof and Pajuste (2005), a higher disclosure level is associated with higher resource availability to a firm. Disclosure is a direct financial cost. In times of financial difficulties and limited resource availability, the efforts and money spent on voluntary CG disclosure may well be saved to reduce operating costs. Firms in financial 'dire straits' may prefer not to engage too much in voluntary disclosure so as not to alarm the investors (*ibid*, 2005, p. 186). On the other hand, a resourceful firm may attract attention from various stakeholders and thus face a higher demand for disclosure. To coordinate business activities and satisfy information needs of overseas financiers, the firm faces greater demand for information from customers, suppliers, analysts, and capital providers. It will be in the interests of the firm to improve voluntary disclosure to increase the marketability of its securities (Cooke, 1989a). Indeed, Cooke (1992) finds empirical evidence that larger firms, which control larger amount of resources than small firms do, differ significantly from smaller firms on the quantity of disclosure. His findings support Atiase's (1985) hypothesis and concur with the empirical findings by Freeman (1987) that information production for the purpose of identifying mispriced stocks is an increasing function of firm size.

There may be a number of measures that can proxy for a firm's resourcefulness, for example, a bigger amount of total assets (as expressed in, e.g., the natural logarithm (LnTA), a higher profitability (e.g., return on equity, ROE), a larger sales volume (e.g., as expressed in terms of natural logarithm, LnSales), or a lower leverage (e.g., Debt/Total Asset ratio, Debt/TA). Since none of these is arguably a perfect metric to measure a firm's resourcefulness, LnTA is chosen to proxy for a firm's resourcefulness because the amount of total assets under a firm's direct control may better indicate a firm's financial prowess in comparison with other proxies. However, ROE, LnSales, and Debt/TA are employed as control variables in the hypothesis postulated below:

#### Hypothesis 2c

H2c: A firm's voluntary CG disclosure is positively related to the firm's resourcefulness, controlling for profitability, sales, and leverage.

#### iv) Dual-listing

Cooke's (1992) empirical study also shows dual-listed firms disclose more. Dual- or multiple-listed firms are often motivated to disclose differently from single-market listed firms. They have an interest in foreign capital markets because foreign operations are often financed by foreign capital (Choi and Mueller, 1984; Cooke, 1989b). To tap into such capital markets, firms will have to increase their disclosure levels to adapt to local customs, to meet the requirements of banks and other capital suppliers. By increasing the disclosure level, firms assist their capital suppliers to reduce the informational risk, thereby lowering the cost of capital (Spero, 1979). Lang, Raedy, and Yetman (2003) have tested cross-listed firms on the U.S. stock exchanges with non cross-listed firms. They find that cross-listed firms are systematically different. Cross-listed firms typically enjoy higher valuation multiples, lower cost of capital, lower risk of expropriation, or higher expected growth. Because of such characteristics, cross listing (at least on the U.S. exchanges) is often regarded as a strong signal about the quality of a firm's management. The firm is more transparent when there is a higher level of outside investors. Their findings are consistent with the empirical results by Lang, Lins and Miller (2003) who find ADR firms in the U.S. enjoy a lower cost of capital and improved corporate governance around the period of cross-listing. Moreover, Lang, Lins and Miller's findings provide strong evidence that important changes in the information environment of firms occur around the time of cross listing. Such changes are rewarded with high valuations by the market. Hence, it is expected that a positive relationship is present between cross listing and the level of voluntary CG disclosure, as postulated in the hypothesis below:

### Hypothesis 2d

H2d: Firms that are cross-listed voluntarily disclose more information about their corporate governance.

#### v) Duality of Chairman and Chief Executive Officer

Prior to the 1990s, it was not uncommon for firms to have an individual to assume the dual roles of the Chairman and the Chief Executive Officer (CEO). For example, Pi and Timme (1993) study 112 U.S. banks from 1987-1990. They find that approximately 25% of the banks have separate persons carrying the titles of the Chairman and the CEO, while 75% have combined titles. They observe that, on average, banks with one individual performing the dual roles of Chairman/CEO under-perform those banks where the two roles are split between two persons. They conclude that firms with non-split roles of Chairman/CEO may be less inhibited from engaging in non-value maximizing behaviour. There are similar findings for industrial companies over the period 1986-1991 in the U.S. Baliga, Moyer, and Rao (1996) analyse 181 firms and observe that only 12 firms (i.e., 7%) had separate titles over the entire period while 111 firms (i.e., 61%) had combined titles of Chairman/CEO throughout the same time. The remaining 58 firms (i.e., 32%) changed leadership structures over the period under study. Baliga *et al* state that better long-term performance is found in firms where a switch to a split leadership structure had taken place.

Agency theory may offer an explanation as to why the roles of Chairman and CEO held by separate persons may lead to better firm performance. Jensen (1993) argues that the combined roles of Chairman and CEO may give rise to an agency problem, as power and leadership of the firms are concentrated in the same person. Such concentration of power exacerbates potential conflicts of interest between the two roles and decreases the effectiveness of the board in monitoring the CEO. A dual role of Chairman/CEO allows the CEO to exert more power over the decisions and practices of the board, making it more costly for the INEDs to disagree with the other directors on the management's decisions. The duality also permits the CEO to control effectively the amount and type of information available to other board members, rendering the monitoring function of the board on the CEO less effective. To perform the fiduciary role of protecting investors' interests, it is necessary for the board of directors to remain independent of the management in order to be effective in monitoring the executives.

Recent empirical studies are not conclusive on the effect of splitting the dual roles of the Chairman and CEO on firm value. Brickley, Coles, and Jarrell (1997) examine 264 U.S.

firms in which the leadership structure has changed from dual to unitary or the reverse between 1984 and 1991. They find that 102 firms have split the CEO and Chairman titles and 162 firms have given one individual both titles. For those 102 firms that split the titles, Brickley *et al* find the two-day announcement period stock market abnormal returns (CAR) are not significantly different from zero. The evidence seems to suggest that announcements of moves from unitary to dual leadership of Chairman/CEO do not systematically affect shareholder wealth. Similarly, for those 162 firms that announce combined title of Chairman/CEO, the average CAR is not significantly different from zero either. Brickley *et al* conclude that there is no evidence that unitary leadership is associated with inferior accounting and market returns. They attribute the results to two causes. First, no major firm in the U.S. in the sample period had a truly independent outsider as chairman. In almost all cases, the chairman is either the former or the current CEO (i.e., ‘passing the baton’ as in a relay race), or a person with special ties to the firm. Second, when firms separate the titles, the chairmen are almost always people with detailed knowledge about the firm who have relatively high stock ownership. For that reason, the potential agency and information costs problems are not as severe as might have been expected.

Brickley *et al*’s arguments are consistent with the findings by Booth, Cornett, and Tehranian (2002), who study 200 regulated firms (i.e., 100 largest banks and 100 largest utilities) and 100 largest industrial firms in U.S. in 1999. They find that the presence of Chairman/CEO duality in a firm does not affect the percentage of INEDs sitting on the board. Furthermore, Booth *et al* find that in larger firms, there is a tendency for one person to serve as both the Chairman and the CEO. Among their sample groups of firms, they find the banks and utilities are more likely to have the dual roles of Chairman/CEO to be performed by the same person than industrial firms are. Although the duality of Chairman/CEO in a firm implies less effective monitoring by the board of directors, the high degree of regulation in banks and utilities industries can substitute for the monitoring mechanism, thus making the separation of the CEO and Chairman less important in controlling agency conflicts.

For those non-regulated firms, the effects of Chairman/CEO duality in a firm on the firm’s disclosure would vary, however. Cheng and Courtenay (2006) study the voluntary disclosure of 104 Singapore firms in 1998 and 2000. They examine the effects on the voluntary disclosure of firms by factors such as the role played by the board of directors,



board size, and duality of CEO/Chairman. Their empirical findings show that, while the proportion of INEDs has a significant and positive association with the level of voluntary disclosure, the board size and Chairman/CEO duality are not associated with voluntary disclosure. Hence, the impact of split roles of Chairman/CEO on the voluntary CG disclosure is unclear.

Agency theory promulgates that an effective board of directors should be independent from management of a firm, implying that there should be separated roles for the CEO and the Chairman. Although the evidence has not been conclusive about the effect of duality of Chairman/CEO on voluntary disclosure by firms, it can be argued that, judging from the perspective of agency theory and based on the findings of above research studies, a testable hypothesis, Hypothesis 2e, could be postulated as follows:

#### Hypothesis 2e

H2e: Firms that split the roles of CEO and Chairman have a higher voluntary CG disclosure.

To sum up, previous literature shows that the level of voluntary CG disclosure is affected by a firm's board characteristics. Nevertheless, past research studies also indicate that some non-board variables may also affect voluntary CG disclosure. For instance, Haniffa and Cooke (2002) identify a great number of factors and summarize them into three non-mutually exclusive categories of firm-specific characteristics that also impact on a firm's extent of voluntary disclosure. Their work is based on a number of theoretical arguments including agency theory, signalling theory, capital market theory, and cost-benefit theory. These categories are generally referred to as: (i) structure-related variables (e.g., size, leverage, ownership structure, complexity); (ii) performance-related variables (profitability); and (iii) market-related variables (e.g., multiple listing). This study follows Haniffa and Cooke's (2002) approach in searching for control variables that are appropriate to test the hypotheses. They are discussed in the following sub-section.

#### Control Variables

Previous literature has shown that researchers employ a variety of variables in exploring the relationship between voluntary disclosure by a firm and its valuation. Some variables are used in common by researchers as control variables despite that the research questions are different (e.g., Singhvi and Desai, 1971; Choi, 1973; Myers, 1977; Firth, 1979; Schipper, 1981; Cooke, 1989a, 1992; Ahmed and Nicholls, 1994; Wallace, Naser and

Mora, 1994; Zarzeski, 1996; Chen and Jaggi, 2000; Berglof and Pajuste, 2005; Cheung, Connelly, Limpaphayom, and Zhou, 2007). Four control variables are found to be commonly used in the firm valuation and disclosure studies. They are: (i) firm size; (ii) profitability; (iii) leverage; and (iv) sales growth. All these variables are used in this study as control variables in the analysis of the relation between CG disclosure and firm-specific characteristics. Each of them is discussed in turn as follows:

*a) Firm Size*

Previous research suggests that firm size may be important in explaining variability in the extent of disclosure. There may be a greater need for larger firms to raise capital to finance bigger projects at lower costs (Choi, 1973), hence a greater pressure from shareholders, their agents, and analysts for increased disclosures (Schipper, 1981). It is also more likely for large firms to be more closely monitored by the regulatory authorities (Firth, 1979). Therefore, large firms are usually more willing to disclose information to customers, suppliers, and even the public in general (Cooke, 1989).

Sales (expressed as the natural logarithm of net sales, LnSales) is used as the measure of firm size in this study as it is an ‘internally’ determined measure of a firm’s importance as opposed to ‘externally’ determined measure affected by the volatility of market price of the stock (Wallace and Naser, 1995). Sales has been adopted as a proxy for firm size in several prior studies (e.g., Cooke, 1989b, 1992; Ahmed and Nicholls, 1994; Wallace, Naser and Mora, 1994; Chen and Jaggi, 2000).

*b) Profitability*

Profitability has been found to be an important firm-specific variable that affects the extent of disclosure (Cerf, 1961). In an empirical study of 527 annual reports of U.S. firms, Cerf develops an index of disclosure and identifies profitability (measured by net profit divided by net worth) as one of the four key characteristics that are associated with the extent of disclosure.<sup>5</sup> In another study of 155 randomly chosen largest U.S. firms between 1965 and 1966, Singhvi and Desai (1971) also identify profitability (measured by the ratio of net profit to net worth) as a key variable that explains the variability of disclosure. Singhvi and Desai posit that, when the profitability is high, the management may disclose detailed information in order to support the continuance of its positions and compensations. When

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<sup>5</sup> The 4 key characteristics in Cerf’s (1961) study are: (i) company size; (ii) extent of ownership; (iii) profitability; and (iv) method of trading, viz. New York stock Exchange or other exchanges; or Over the Counter Market.

the profitability is low, the management may disclose less in order to cover up the reasons for losses or declining profits. The return on equity (ROE) is the measure for profitability in this study.

c) Leverage

A firm's leverage (or gearing) has been shown to be significantly related to disclosure (e.g., Wallace, Naser, and Mora, 1994; Cooke, 1996; Zarzeski, 1996). In capital market-based economies, companies with a higher proportion of their assets financed by bank borrowings need to disclose more information in their annual reports to meet the needs of their lenders. Information may have to be disclosed to assure bond-holders that the insiders are less likely to bypass their covenant claims (Myers, 1977; Schipper, 1981). This view is consistent with agency theory (Jensen and Meckling, 1976) which suggests that firms with high gearing ratios will incur high monitoring costs. That agency problem, however, may be alleviated by more comprehensive levels of disclosure.

The debt ratio (i.e., Debt/Total Assets expressed as a percentage, Debt/TA) is used as the variable for measuring a firm's leverage in this study.

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d) Sales growth

High growth companies generally require more capital. Their need for external funds is expected to be greater than those firms whose business growth is static. Moreover, sales is a clear indicator of a firm's performance; and better performing firms tend to disclose more (Berglof and Pajuste, 2005). The arguments above are in line of the hypothesis postulated by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, 2000b), whose substitute model of dividends suggests that "firms with better growth prospects have a stronger incentive to establish a reputation for moderation in expropriating shareholders since they have a greater potential need for external finance"(LLSV, 2000b, p. 8).

In this study, sales growth is measured by the percentage growth in sales over the firm's sales in the previous year (SaleGrow), i.e.,  $(Sales_t - Sales_{t-1}) \times 100 / (Sales_{t-1})$ . The higher the growth rate, the more the voluntary CG disclosure is expected.

These sub-hypotheses under the family Hypothesis 2 are summarized in Table 6.1 below. The expected signs for the company characteristics variables and control variables on the impact of the firm's voluntary CG disclosure are presented in the last column.

**Table 6.1 Summary of expected impact of company characteristics variables and control variables on CG disclosure**

Hypothesis	Variable	Nature of variable	Measurements level & scale	Expected sign on CG disclosure
<b>Company characteristics variables</b>				
H2a	Directors ownership %	numerical	Continuous, Ratio.	+ and – , due to non-monotonous relationship
H2b_1	No. of INEDs	numerical	Discrete, Interval	+
H2b_2	% of INEDs on board	numerical	Continuous, Ratio.	+
H2c	Total assets	numerical	Continuous, Ratio.	+
H2d	Dual listing	categorical	Discrete, Nominal	+ if dual listed
H2e	Split roles of CEO/Chairman	categorical	Discrete, Nominal	+ if roles are split
<b>Control variables</b>				
	Profitability (ROE)	numerical	Continuous, Ratio.	+
	Sales (LnSales)	numerical	Continuous, Ratio.	+
	Debt ratio (Debt/TA)	numerical	Continuous, Ratio.	+
	Sales growth	numerical	Continuous, Ratio.	+

It should be pointed out that the control variables listed in Table 6.1 are not exhaustive. Other factors that are non-specific to the firm will also affect voluntary CG disclosure. For example, Zarzeski (1996) presents an *International Disclosure Model* in which she suggests *cultural forces* as another set of independent variables that would affect investor-oriented disclosure practices.<sup>6</sup> Her study finds that the secretiveness of a culture underlies disclosure practices of the firms. Local enterprises disclose their information commensurate with the secretiveness of their local culture.

The sample firms in this study are either domiciled in Hong Kong or their main sales revenue are derived from Hong Kong (which is the definition of the stocks included in the Hang Seng Hong Kong SmallCap, MidCap, and LargeCap Indices). In Hong Kong, a majority of the listed firms are owned and managed by Chinese families (Mok, Lam, and Cheung, 1992; Lam, Mok, Cheung, and Yam, 1994; HKSA, 1997; Ho, Lam, and Sami,

<sup>6</sup> The other set being the market forces which include the *proportion of foreign sales to total sales*, *firm size*, and the *debt ratio*. Since by default, the constituent stocks of HSHKI comprise only firms that derive their business mainly from Hong Kong, the proportion of foreign sales to total sales will not be covered in this study. The four cultural forces are based on Hofstede's (1980) four cultural dimensions: *uncertainty avoidance*, *individualism-collectivism*, *masculinity-femininity*, and *power distance*.

2004). The cultural forces affecting the firms in this study are generally the same (thus controlled for); hence, market forces can be expected to constitute the major explanatory variables of a firm's voluntary disclosure of the CG structure and practices, according to the categorization of variables by Zarzeski. Such market forces may include, among others, firm size, leverage, business growth potential, dual-listing status, and the proportion of Independent Non-Executive Directors (INEDs) on the board.

Similarly, the legal origin, legal framework, capital market structure, and the presence/absence of various external CG mechanisms (as discussed in Chapter 2) would also affect the level of voluntary disclosure. All the sample firms in this study, being constituent firms of the Hang Seng HK Composite Index, are subject to the same regulatory environment and financial reporting standards. For instance, all listed firms on the HKEx are subject to the same set of Companies Ordinance, Securities and Futures Ordinance, and the listing rules of the Hong Kong Stock Exchange. Prior to the implementation of Appendix 13 of the HKEx *Listing Rules* in January 2005, all the listed firms were encouraged to disclose their corporate governance practices since 2002 (after the SCCLR report 2001 as has been discussed in Chapter 5 of this thesis). However, there was no penalty for non-disclosure prior to 2005, the year *Appendix 13* came to full enforcement. As such, some firms chose not to disclose their CG information as much as desired by the regulators, even though they were kept informed about the forthcoming CG disclosure requirements. Variations in levels of disclosure were therefore expected. Apart from those structure-related or performance-related variables as suggested by Haniffa and Cooke (2002), the variations in voluntary CG disclosure would most likely be caused by other managerial quality variables, depending on the management's initiatives, intention, willingness, efforts, and commitment in reducing the information asymmetry between insiders and outsiders. These differences in disclosure contents are expected to be perceived, recognised, and valued differently by outside investors because investors would feel more comfortable to leave their investments in the hands of good quality managers, who will look after their interests with the vigilance they deserve.

As the selected sample firms vary in their business nature (see Chapter 8: Data Collection) and market capitalization (see Chapter 9: Descriptive Statistics), their disclosure of corporate governance practices may vary. For example, some firms may have cross-listings on other stock exchanges in addition to the HKEx. They may have a motivation to

voluntarily disclose more than the mandatory requirements prescribed by HKEx. This leads to the development of a third hypothesis as presented in the following sub-section.

### **6.3.3 Market capitalization and voluntary CG disclosure**

Prior research on disclosure of firms are mainly cross-countries studies with focus on large firms (e.g., Wallace and Naser, 1995; Chau and Gray, 2002; Cheung, Connelly, Limpaphayom, and Zhou, 2007). This study differs from prior studies in that the investigation on the voluntary disclosure practices will be made separately for sample firms of various size groups in terms of market capitalization, namely, the SmallCap, MidCap, and LargeCap firms in the Hang Seng HK Composite Index series. These sample firms are operated under a highly acclaimed investor protection legal regime and a business environment that is predominantly dominated and controlled by family-members. There are benefits to carry out analyses on separate groups of firms, controlling for firm size. Firstly, the characteristics of LargeCap firms are different from SmallCap firms. LargeCap firms tend to be more complex in organization structure and more diverse in type of business they operate in than SmallCap firms are. For this reason, the information asymmetry between insiders and outsiders for the LargeCap firms are likely to be wider. Bushman, Piotroski, and Smith (2004) argue that complex firms are more likely to face a demand for segment reporting than simple firms, before the time when segment reporting becomes a mandatory reporting requirement. Hence, the voluntary disclosure behaviour of LargeCap and SmallCap firms is expected to differ.

Secondly, the amount of private information of the firm disclosed through analysts following varies between LargeCap and SmallCap firms. LargeCap firms, by default with higher market value, tend to attract more analysts following who serve as information agents as well as providers between the outsiders and the insiders of the firms. Analysts produce reports on firms and make recommendations to their clients on investment strategies as to buy, hold, or sell the stocks of these firms based on their understanding and analysis of those firms. In this respect, analysts provide a service in supplementing the information quantity voluntarily disclosed by the firms. By providing more reports and recommendations on their selected firms (usually larger firms), these information agents add to the aggregate information set, thereby reducing the information gap between the insiders and the outsiders, for these firms. Consequently, LargeCap firms and SmallCap firms may have different information quantity available to prospective investors, even if

both types of firms have disclosed voluntarily the same amount of information to the market. It is therefore desirable, if not necessary, to distinguish the LargeCap firms from SmallCap firms in analyzing the relationship between voluntary disclosure and firm valuation in order to control for this factor.

Thirdly, LargeCap firms (many of them are ‘blue chips’) have a longer listing history than SmallCap firms do in general. Many of the LargeCap firms are well established with good market reputation. Over the years, outside investors may have already acquired certain knowledge about the management style, recruitment principles, and business policies of the LargeCap firms. They may have established some level of understanding and trust in these firms. In contrast, outside investors may not know much about the SmallCap firms whose listing history may be relatively short. SmallCap firms are generally well known for adopting a more aggressive approach in their investment strategies and policies, which often leads to a need for closer monitoring in their usage of funds and more scrutiny on their business strategies. Investors’ expectations on the corporate governance of LargeCap firms and SmallCap firms may therefore be drastically different (measurements of voluntary disclosure and other variables will be discussed in detail in Chapter 7: Research Design).

Finally, the tendency to seek cross-listing is higher for large firms than small firms. In countries with weak investor protections and disclosure standards, firms may choose to cross-list in another country with strong investor protections and disclosure requirements (e.g., the U.S. or the U.K.) in order to increase the level of investor protection for their minority shareholders (Reese and Weisbach, 2002). Cross listing is voluntary, and incurs additional costs to firms. It is more likely for LargeCap firms than SmallCap firms to incur hefty costs to tap into foreign capital markets. By cross listing, firms indicate their willingness to comply with an additional set of accounting and disclosure requirements of a foreign country. The requirements are not applicable to those firms that are not cross-listed. Therefore, *ceteris paribus*, the following hypothesis (stated in alternative form) can be tested:

#### Hypothesis 3(H3)

H3: There are systematic differences in the voluntary CG disclosure between large-cap firms and small-cap firms in both the level of disclosure and the value relevance of disclosure.

While there may be marked differences between the LargeCap firms and SmallCap firms in terms of firm characteristics, the differences may not be so distinct between the LargeCap and MidCap firms. Due to the fluctuations in market capitalization value, there is a possibility for a MidCap firm to drop out of the MidCap Firm category and be demoted to the SmallCap Firm category when other upcoming SmallCap firms surpass its market value. It is an empirical issue to find out if the characteristics of MidCap firms in terms of CG disclosure are similar to LargeCap firms or to SmallCap firms. In order to test if there are systematic differences amongst the LargeCap, MidCap, and SmallCap firms in terms of their voluntary CG disclosure, firm valuation as proxied by Tobin's  $q$ , and the value relevance of CG disclosure (i.e., the strength of relationship between CG disclosure and  $q$ ), Hypothesis 3 is decomposed into three supplementary hypotheses, which are stated as follows:

Hypothesis 3a:

H3a: There are systematic differences in the voluntary CG disclosure of LargeCap, MidCap, and SmallCap firms.

Hypothesis 3b:

H3b: There are systematic differences in the market valuation amongst LargeCap, MidCap, and SmallCap firms.

Hypothesis 3c, 3d and 3e:

H3c: There are systematic differences in the strength of relationship between voluntary CG disclosure and firm valuation among LargeCap, MidCap, and SmallCap firms.

As three types of firms are involved, a pair-wise comparison is needed to accept or reject any one of these sub-hypotheses. In order to reject the null hypothesis that there is no difference amongst LargeCap, MidCap, and SmallCap firms in terms of, say, CG disclosure, a higher threshold is usually required, that is to say, all three pair-comparisons must be shown to have no statistically significant difference (i.e., CGDscore of LargeCap firms = CGDscore of MidCap firms = CGDscore of SmallCap firms).

The disclosure of CG information of a firm by the insiders is a means to give assurance to the outside investors that their investments are safe and not subject to insiders' expropriation. Outside investors could also seek such assurance through the demand of regular returns from their investments in the form of dividend payments. In the following sub-section, Section 6.3.4, the role of dividend payout in a firm's CG will be discussed,



and the rationale for dividend payout to be construed as a substitute for investor protection will be presented.

#### **6.3.4 Dividend payout and CG disclosure**

In a world of perfect capital markets, dividends payout are generally considered as not having any impact on firm value (Miller and Modigliani, 1961). However, in an imperfect capital market, a mature firm with stable cash flows but paying too small a dividend may run the risk of investing the retained profits in projects with insufficient net present value to justify its cost of capital. On the other hand, for some prospering high-growth firms, paying too high a dividend to the investors will decrease the level of retained profits within the firm, thus reducing the firm's financial flexibility and stripping the firm of valuable investment opportunities (Baker and Powell, 2000). Hence, managers of a firm tend to deliberate on the decisions made with regard to dividends because any dividend decisions will convey certain meanings to the outsiders. Dividends are often considered as signals to the investors, as will be discussed in more details in the following sub-section.

##### *i) Dividends serve as signals*

Lintner (1956) argues that a major change in earnings shift from existing dividend rate is the most important determinant of a company's dividend decisions. The change in dividend rate therefore may carry a strong signal to the market. He suggests a behavioural model of dividend policy that states two implications. First, shareholders always prefer a steady stream of dividends, thus the managers have an incentive to smooth dividends in the short run to avoid frequent changes. Second, an increase in dividend rate is a signal about a permanent shift in earnings rather than a signal about future earnings growth; and consequently about future firm value. In his own words, Lintner states:

“It was equally clear that these elements of inertia and conservatism ... were strong enough that most managements sought to avoid making changes in their dividend rates that might have to be reversed within a year or so. This conservatism and effort to avoid erratic changes in rates very generally resulted in the development of reasonably consistent patterns of behaviour in dividend decisions.” (*ibid*, 1956, p. 99-100)

Lintner (1956) argues that a policy to stabilize dividend distributions would give a consistency in the pattern of dividend action and would help to minimize adverse stockholder reactions. It follows that:

“...any reason which would lead management to decide to change an existing rate ... had to seem prudent and convincing to officers and directors themselves

and had to be of a character which provided strong motivations to management.”  
(*ibid*, 1956, p. 100)

He also comments that, when a dividend rate is to be reduced,

“Managements felt that it was both fair and prudent for dividends to the shareholders to reflect some part of any substantial or continued decline in earnings, and that under these circumstances stockholders would understand and accept the cut.” (*ibid*, 1956, p. 100-101)

His views are supported by other empirical researchers such as Watts (1973) who agrees that information on future earnings dividends may be contained in dividends. However, the information content of dividends is trivial. It is modified by how quickly the firm adjusts actual dividends to the desired level of dividends and also by the firm’s target dividend payout rate.

#### ii) Market reacts to signals conveyed by dividends

There are different findings as to whether dividend carries any signal to the market. Gonedes (1978) find no evidence to support the view that dividends are signals that reflect information beyond what has been reflected in contemporaneous income signal. On the other hand, Brickley (1983) finds significant differences in market reactions to firms’ announcing regular (unlabelled) dividends increases to firms declaring specially designated dividends (SDDs) such as ‘extra’, ‘special’ or ‘extraordinary’ dividends. Regular dividend increases and SDDs are both dividend decisions which represent cash disbursements to shareholders with identical tax consequences. Any difference in the market reaction to the labelling of a dividend increase is attributable to a difference in the signal or ‘message’ conveyed by management through the label. A comparison is made of the three groups of firms, namely, those announcing SDDs, those announcing regular dividend increases, and those announcing no change in the dividend payout. Brickley finds empirical support for the argument that a regular dividend increase conveys more positive information than an SDD as reflected by the dividend payouts in the year following the dividend increases. He interprets the result as consistent with the signalling notion of dividends, which implies that for the firms giving regular dividend increase, there is statistically larger earnings changes in the fiscal year after the dividend announcement.

Aharony and Dotan (1994) test if quarterly cash dividends announcements would convey useful information about a firm’s future profitability. They use changes in the quarterly dividends and unexpected accounting earnings in subsequent quarters of 838 NYSE firms from 1967 to 1990. They classify any increase in quarterly dividends as “good news” and

any decrease as “bad news” to construct a naïve expectations model in which no change in dividends is expected. In their empirical findings, there is a strong association between dividend changes and subsequent unexpected earnings (e.g., earnings continue to increase for at least 4 quarters after the quarterly dividend change), which does not disappear when current unexpected earnings are introduced as an explanatory variable. Aharony and Dotan conclude that their findings provide strong support to the hypothesis that quarterly dividend changes are predictive of future earnings. Dividend changes do convey information and can be interpreted as useful signals as to future earnings.

Benartzi, Michaely and Thaler (1997) challenge the above view, however. Contrary to Brickley (1983) and Aharony and Dotan (1994), they do not find any empirical evidence to support the view that dividend changes incorporate information content about future earnings changes in their 4,996 samples (firm-years) from the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) from 1979 to 1991. Benartzi *et al*’s findings are consistent with those of Watts’ (1973) in that dividends contain only trivial information on the firm’s future earnings. A strong past and concurrent link between earnings and dividend changes is, however, observed. The predictive value of changes in dividends seems to be minimal. Nevertheless, Benartzi *et al* also find some evidence that dividend-increasing firms are less likely to have subsequent earnings decreases when compared to firms that do not change their dividend despite similar earnings growth. In this sense, a change in dividends does signal a message about the present that the current increase in earnings is permanent.

iii) Managers’ dividend decisions are shaped by investors’ expectation

The level of dividend can be taken as a signal to the outsiders on how the insiders perceive the prospects of the firm. However, managers tend to maintain the same level of dividend payout over the years unless a permanent change in the business outlook is looming. In the face of any adverse development in sales revenue that is considered as temporary, the board of directors may still approve the same level of dividend payout as in the previous year. By the same argument, any increases in revenue that is regarded by management as short-lived and not permanent over the long run will not spur the board to increase the dividend payout. As a result, dividend payout will be maintained at the same level as in the previous year despite the profit for the current year has much improved. From a signalling perspective about future firm value, firms seem to prefer a stable dividend payout policy over the years unless there are substantial changes in their business operation.

While the level of dividend payout (and any changes in the level of dividend payout) may be endogenously determined and controlled by the board of directors of a firm, outside investors can make a demand for regular payout of dividends, though subject to the constraints imposed by company laws in most countries. A survey of ordinary investors shows that, when there is no tax difference between dividends and capital gains, small individual investors have a strong preference to receive dividends (Dong, Robinson, and Veld, 2005). Individual investors prefer cash dividends to stock dividends, and prefer stock dividends to no dividends at all. The findings support the signalling theories of Bhattacharya (1979) and Miller and Rock (1985).

If the investors' demand for regular dividends is not met satisfactorily, investors may express their views in the annual general meetings of the firm. There are legitimate means or actions that the investors may take in their fight for dividends. For instance, they may strive to appoint a director to speak for their interest, instigate a proxy fight, demand an overhaul of management, initiate acquisition or hostile takeover, etc. Failing all that, their last resort is to sell off their shares of the firms (or refuse to subscribe for new shares), the result of which would be a prolonged lower-than-expected market valuation of the firm and creating a higher cost of finance to the firm. To avoid such undesirable scenarios, the board of directors can be expected to not only address the concerns of the insiders (i.e., the needs of management), but also consider expectations from the outside investors – including those of block-holders. Short, Zhang and Keasey (2002) find evidence in the U.K. in support of the hypothesis that a negative association is present between managerial ownership and dividend payout, but there is a positive association between block-holder ownership and dividends.

*iv) Predominant shareholders dominating dividend policies*

In the presence of a predominant shareholder in a firm such as the case of most Hong Kong firms with family ownership exceeding 50% of a firm's equity, outside minority shareholders have fewer means to air their grievances or disappointment of dividend payouts than their counterparts in the U.S. or U.K. A predominant shareholder can veto any unfavourable motions in the annual general meetings by calling a poll. Any prospect of hostile takeover may be squashed whenever a predominant shareholder is present. The only weapon the outsiders have is to threaten to sell off their shares in the market at a deep discounted price. According to the Listing Rule of HKEx, listed firms have to allow at least 25% of their issued share capital to be held by the public at all times (HKEx *Listing Rule*, 2005, Sect. 8.08). Any consensus effort to sell off all their shares by these 25%

equity holders may cause the share price to drop, rendering a blow to the firm's market valuation as well as the firm's reputation. Provided the majority shareholder cares about the firm valuation, the threat to 'vote with their feet' of the disgruntled minority shareholders can still be an effective measure to channel through their request for a decent return on their investment in the form of dividend payout.

In sum, managers place high importance on maintaining the continuity of dividends. They believe that there is an impact of dividend policy on stock prices, and are concerned about the signals that dividend change may provide to investors (Baker and Powell, 2000, p. 31). In this sense, dividend payout can serve as a tool in monitoring the insiders (Gugler, 2003), keeping the managers vigilant (Easterbrook, 1984; Jensen, 1986), and hence having a corporate governance role to play in an environment where there are insufficient monitors (Borokhovich, Brunarski, Harman, and Kehr, 2005). One of the examples of insufficient monitoring of insiders is the presence of a predominant shareholder, who by capturing 50% or more share ownership enjoys almost unchecked power inside the board of directors. The following sub-section discusses the corporate governance role of dividends.

*v) Dividend payout as a mechanism for corporate governance*

Dividend payout has always been regarded as a monitoring device for agency costs. Rozeff (1982) and Easterbrook (1984) argue that, to make cash dividends payout, a firm is forced to go to the capital market more frequently, thereby subjecting the firm to increased scrutiny from the capital market, and hence reducing its agency costs. Jensen (1986) emphasizes the importance of disgorgement of free cash flow to shareholders: it reduces the resources under the control of the managers, thereby reducing managers' power and preventing firms from wasting resources on low-return projects. These researchers, however, have not stated clearly whether the dividend payout policy is an endogenous management decision or is indeed a response from the pressure of shareholders.

There are recent studies that directly examine the dividend payout of a firm in light of its corporate governance mechanism. Faccio, Lang, and Young (2001) find evidence that support Jensen's notion. The payment of dividends to shareholders can reduce the resources available to managers to invest in wealth-reducing projects or to waste on excessive perquisites. Distributing dividends, by removing corporate wealth from insider control, has a basic role to play in limiting insider expropriation. Faccio *et al*'s empirical findings suggest that investors anticipate strongly the expropriation within corporations where there is a low ratio of ownership rights to control rights (e.g., firms that are tightly

affiliated to a group). As a result, those firms pay higher dividends to allay these concerns of the insiders, especially when the firms have to compete for capital. Faccio *et al* argue that dividend payouts are significantly impacted by how vulnerable the minority shareholders are to the firm's controlling shareholders' expropriation. Hence, dividends can be interpreted as a means for limiting expropriation.

It must be pointed out that Faccio *et al*'s study is a comparative study of European firms and Asian firms. From their empirical findings, they observe that group-affiliated firms in Western Europe pay significantly higher dividend rates than firms in East Asia. Moreover, in Europe, the presence of other large shareholders appears to help contain the controlling shareholder's expropriation of minority shareholders. In East Asia, in contrast, they appear to collude in that expropriation.

Mitton (2004) observes that firms with higher corporate governance ratings have higher dividend payouts<sup>7</sup> in a cross-country study of 365 firms from 19 emerging markets (including Hong Kong) using the firm-specific corporate governance ratings developed by Credit Lyonnais Securities Asia (CLSA). His empirical result is consistent with the outcome agency model of dividends postulated by La Porta, Lopes-de-Silanes, Shleifer, and Vishny (LLSV, 2000b)<sup>8</sup>, which states that investors afforded with stronger rights will use those rights to extract dividends from the firm. However, such a positive relationship is limited primarily to countries with strong investor protection. Similar relationship may not exist in countries with weak legal investor protection.

Both LLSV (2000) and Mitton (2004) find empirical evidence that, in countries with strong investor protection, there is a stronger *negative* relationship between growth opportunities and dividend payouts. Their findings imply that, when shareholders within a strong protection regime perceive that their rights are well protected, they are "more willing to let firms with good growth opportunities retain cash, being confident that they will share in the payoff from good projects later on" (Mitton, 2004, p. 411).

In contrast, when shareholders perceive that their rights are poorly protected, they "may be more haphazard in their desire for dividends, trying to extract whatever value they can,

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<sup>7</sup> Mitton does not take into account the insider ownership of the firms, however. In emerging markets, there is more often than not a prevalence of a predominant shareholder whose presence renders the minority shareholders powerless to seek legitimate protection even though the firm is operating under a strong legal investor protection regime.

<sup>8</sup> See sub-section f) below.

regardless of the firm's growth opportunities, before being expropriated" (*ibid*, 2004, p.411). Gugler (2003) comments that dividend payouts are "the result of effective pressure by minority shareholders to force corporate insiders to disgorge cash" (*ibid*, 2003, p.1299); and find evidence in his sample of Austrian firms to support LLSV's (2000) outcome model of dividends that "corporate outsiders force corporate insiders to disgorge cash if their legal rights allow them to do so" (*ibid*, 2003, p. 1318).

Finally, Borokhovich, Brunarski, Harman and Kehr (2005) provide empirical evidence that support the view that distributing dividends reduces agency costs. Using three common measures (i.e., the independence of the board of directors, the percentage of votes held by outside block-holders, and the presence of poison pills in the firm's charter) to proxy agency costs, they study 776 firms that announced quarterly dividend increase from 1992 to 1999. The notion is that, if dividends are capable of benefiting shareholders by reducing agency costs, the stock price reaction to positive dividend changes will differ from firm to firm, depending upon the firm's level of agency costs. It means that, given a dividend surprise, firms with lower agency costs should benefit less. Their empirical findings indicate a significant negative relation between the stock-price reaction to dividend increases and the presence of an independent board of directors. Borokhovich *et al* conclude that dividend payouts serve as a corporate governance mechanism to reduce agency costs.

The above findings lend theoretical support to the postulation of the fourth main hypothesis of this study, which is derived from La Porta, Lopes-de-Silanes, Shleifer, and Vishny's (LLSV, 2000b) dividend outcome model to be discussed below.

vi) Dividend outcome model by LLSV (2000b)

Given that a large majority of listed firms in markets such as Hong Kong are under tight control by members of the same family who share the insider information much more conveniently, can the outsiders (i.e., the investors) seek any protection from potential expropriation by the insiders other than resorting to legal redress? Are there any alternatives to merely pricing the firm at a lesser value?

La Porta, Lopes-de-Silanes, Shleifer, and Vishny (LLSV, 2000b) propose a model in which the investors can use dividends as a substitute for legal protection. They argue that a firm has the need to establish a reputation for moderation in expropriating shareholders' wealth if it desires external capital on attractive terms. Paying dividends is one of the ways to

establish such a reputation. LLSV regard that a good reputation for treating fairly all shareholders – majority and minority alike – is highly valuable for firms operating in countries with weak legal protection as the minority shareholders have nothing else to rely on. To start a legal contest otherwise with majority shareholders would likely incur more costs than benefits to the minority shareholders, who may as well sell off their stakes under such a scenario. LLSV conjecture that the need for paying dividends to establish a reputation is *greater* for firms in poorer investor protection countries. This is the *supply* side argument of the outcome agency model of dividends.

LLSV (2000b) also propose another reasoning for their hypothesis. They posit that investors (i.e., external funds providers) would demand the firm to pay out as much in dividends as financially feasible instead of leaving any undistributed earnings inside the firm. This is because the temptation is greater for managers (or insiders) to expropriate the surplus cash for their own benefits when the minority shareholders have no effective way to monitor the agents (i.e., the managers), or when the outsiders have no legal way to access the same information that the insiders may possess. LLSV argue that, other things being equal, dividend payout ratios should be *higher* in countries with weaker legal protection than those with stronger protection of minority shareholders. This is referred to as the *demand* side argument of the outcome agency model.

Both the supply side and the demand side argument of the dividend outcome model can be applied to firms operating *even in a strong legal investor protection regime*. Firms with greater corporate governance disclosure can be expected to stand out from the crowd to signal to investors their willingness to treat all shareholders fairly, whenever the firms are perceived as exhibiting comparable levels of agency or entrenchment problems. They plausibly feel the same need to establish a reputation to be fair, and such need is arguably stronger for those firms that are in greater need of external funds for future development.

SmallCap firms are a good case in point. SmallCap firms do not often attract international investors' attention or analysts following (Bhushan, 1989a). Unlike LargeCap firms, SmallCap firms may not generate sufficient interest to the analysts to follow or make a recommendation on their stocks. Yet, SmallCap firms may still need external capital for business development. By voluntarily disclosing more corporate governance practices, and by paying dividends at a higher payout ratio, these firms can signal to the external investors that they would be handling all outsiders' funds fairly.



Likewise, given the same growth opportunities among firms, the outside investors need information to decide which firm is more trust-worthy in terms of protecting their investments. In the absence of detailed knowledge of how the firm is being run on a day-to-day basis, the outside investors may be expected to rely on the extent of voluntary corporate governance disclosure and the dividend payout to cast their vote of confidence. Comparing like with like, a firm with *higher* corporate governance voluntary disclosure ranking may signal to the investors that the management of the firm is more willing to treat all investors fairly. If the investors are not so assured, the investors will most likely press for a *higher* dividend payout. Unless the outside investors feel satisfied and secure that their investments are safe, they are not expected to be contented with any low level of dividend payout and would sell out all their holdings of the firm's stock. Therefore, *ceteris paribus*, it can be hypothesized that:

Hypothesis 4(H4)

H<sub>4</sub>: Under a strong legal protection regime, high corporate governance ranking firms have lower dividend payout ratios, *ceteris paribus*, than those of low corporate governance ranking firms.

In the above-mentioned hypothesis, high corporate governance ranking firms are proxied by the extent of voluntary disclosure of corporate governance structure and practices. The more the voluntary disclosure is, the higher is the corporate governance ranking of the firm.

### **6.3.5 Dividend payout, corporate governance, and ownership structure**

To the minority shareholders of small firms, their risk of expropriation comes from two sources: controlling shareholders and entrenched management (Ang, Cole and Lin, 2000; Bebchuk and Cohen, 2005). The higher the insider ownership of a firm's equity, the more likely the entrenchment problem to exist and that the insiders are more inclined to retain profits within the firm. In an empirical study of 211 U.K. firms between 1988 and 1992, Short, Zhang and Keasey (2002) find strong evidence in support of the hypothesis that a negative association exists between dividend payout and managerial ownership. However, as they use a dummy variable 1 to proxy management ownership being greater than or equal to 5% (and 0 for otherwise), their empirical analysis cannot differentiate the impact on dividend payout along the continuum of levels of managerial ownership.

Short *et al*'s results are in line with the empirical findings by Schooley and Barney (1994), who find a non-monotonic relationship between the percentage of stock owned by the CEO

and the dividend yield in 235 large, U.S. industrial firms around 1980. Their study shows that CEO ownership is negatively related to dividend yield<sup>9</sup> over low levels of ownership, while the relation becomes positive when CEO ownership is large. Schooley and Barney conclude that, beyond a certain level of insider ownership, entrenchment may occur<sup>10</sup> and dividends may then become a more effective tool for reducing agency costs.

Farinha (2003) tests the hypothesis that insider ownership affects dividend policies in another context, using U.K. data from 600 firms for two separate periods of time (1987-1991 and 1992-1996). He detects a U-shape relationship between the two variables. Moreover, he finds that the entrenchment levels for both small firms and large firms in 1991 are approximately the same (around 31% insider ownership); but the levels are different in 1996 (i.e., around 16% for small firms and 32% for large firms). It should be pointed out, however, that both Schooley and Barney's and Farinha's sample firms operate under strong legal regimes (i.e., the U.S. and U.K. respectively) *and* the ownership of firms tend to be highly diverse. Whether the presence of a predominant shareholder affects the non-linear relationship between ownership and dividends remains to be tested. This study intends to fill this gap.

Going along the same logic of the dividend agency outcome model as proposed by LLSV (2000b) – i.e., outside investors will not be contented to accept a low level of dividend payout ratio unless they feel their interests are adequately protected – outsiders can be expected to press for a high dividend payout. They may be willing to accept a lower level of dividend payouts when they are fully informed that their own interests are in alignment with those of the insider's (i.e., the management's) interests. Such scenario would be the case when the insiders are either having nil or negligible shareholding (thus likely high agency cost) or they are firmly entrenched (i.e., a predominant owner). Morck, Shleifer, and Vishny (1988) have shown that a firm's Tobin's  $q$  goes up as insider ownership increases from the low end up to 5% ownership, and falls as entrenchment creeps in when insider ownership increases to 25% and beyond.

It follows that, within similar grouping of corporate governance disclosure by rank, firms that are prone to the agency problem (as proxied by a low level of insider ownership) and

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<sup>9</sup> Schooley and Barney (1994) also test the relation using the dividend payout ratio as the dependent variable for robustness test. The estimated coefficients are found to have the same sign and approximately the same level of statistical significance. Only the coefficient of determination is lower.

<sup>10</sup> The point of entrenchment is estimated by differentiating dividend yield with respect to CEO ownership to find the minimum, which is roughly 14.9% CEO ownership in Schooley and Barney's sample.

firms that may suffer entrenchment problems (as proxied by a high level of insider ownership) are most vulnerable to non-alignment of interests between insiders and outsiders. Such firms would therefore be expected to respond to outsiders' demand by distributing dividend at higher payout ratios than firms which have moderate insiders' ownership (as proxied by a middle-range insider ownership).

While the critical entrenchment level may vary from country to country, in a situation where a predominant shareholder prevails, entrenchment is certain to happen when insiders capture 50% (or even less in the case of LargeCap firms, depending on how diffused the ownership of the firm is) of equity ownership. The ownership threshold for entrenchment tends to be lower for LargeCap firms than SmallCap firms, as the required capital outlay to evict a substantial shareholder is much larger. As the Listing Rules of HKEx require all listed firms to have a float of at least 25% of shares to the public, a predominant shareholder cannot hold more than 75% of the share capital if the firm is to remain a listed company. A majority shareholder may therefore afford to allow a float of 25% to 50% ownership without jeopardizing its predominance over the firm. All in all, across the ownership continuum, it can be broadly hypothesized that firms that are prone to the agency problem (as proxied by 0-25% insider ownership) and firms that suffer from entrenchment problem (as proxied by over 50% insider ownership) would have a higher dividend payout ratio than firms which are free from these problems (as proxied by 25%-50% insider ownership). Specifically, a testable hypothesis H5 is suggested as follows:

Hypothesis 5(H5)

H<sub>5</sub>: Firms that have insider ownership of 25%-50% exhibit the lowest dividend payout ratio, comparing with firms that have insider ownership of 0-25% or over 50%, ceteris paribus.<sup>11</sup>

Therefore, both variables – the firm size (as proxied by the market capitalization) and directors' ownership – are controlled in this study. The next chapter, Chapter 7, will specify the methodology to test these hypotheses.

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<sup>11</sup> It must be pointed out that the distinction of 0, 25%, and over 50% insider ownership in this study is only a crude way of classifying insider ownership along a continuum. Previous research such as Schooley and Barney (1994), Ang, Cole and Lin (2000), Farinha (2003), and Bebchuk and Cohen (2005), among others, have shown that entrenchment may start to emerge from as low as 15% insider ownership. The market capitalisation of the firm – whether it is a large-cap or small-cap corporation – is clearly one of the factors that determine how easily a single shareholder of sizeable insider ownership can be entrenched or evicted from the management of the firm.

## 6.4 Summary

The rationale behind the hypotheses developed in this study follows from the signalling theory of voluntary disclosure (Ross, 1979; Milgrom, 1981; Verrecchia, 1983; Dye, 1985; Lev and Penman, 1990), which states that voluntary disclosure would benefit the firm. Applying this principle to a firm's corporate governance disclosure in Hong Kong where there is a strong investor protection, the marginal benefits to the firm thus incurred could lead to either a higher market valuation of the firm by the outside investors, or a lower dividend payout ratio (as conjectured by LLSV, 2000b). However, recent research also suggests that ownership structure of a firm has a mitigating impact on the dividend payout (Farinha, 2003) by showing a U-shaped relationship between dividend payouts and insider ownership in the U.K. This study intends to test empirically in a business environment where predominant ownership structure prevails, whether voluntary disclosure has a role to play in affecting a firm's valuation and dividend payout.

Four research questions are raised: (i) Would voluntary disclosure of corporate governance (CG) affect a firm's valuation? (ii) Does concentrated ownership structure have any effect on the level of a firm's voluntarily disclose of CG? (iii) Would firms of different market capitalisations behave differently in their voluntary CG disclosure? (iv) Would voluntary disclosure of CG be a substitute for dividend payouts, given the presence of a predominant insider shareholder?

The hypotheses in this chapter are derived from these four research questions, which are to be tested using multiple regression techniques. In the following two chapters, Chapter 7 and Chapter 8, the variables to be used in this study, the research design, and the methodology will be presented. The explanation on the selection of variables and their constructions will be discussed in Chapter 7 while the methodology is to be discussed in Chapter 8.

## Chapter 7: Definitions and Computations of Variables

### 7.1 Introduction

In the previous chapter of this study, 13 hypotheses have been put forward based on the four major research questions as discussed in earlier chapters. The selection of sample firms and the construction of the sample frame for this study will be explained in the next chapter (i.e., Chapter 8), where empirical models are also developed and presented. In the current chapter, Chapter 7, an introduction of the variables that are used in the models is provided. It states the definitions of the variables, specifies the source of information, and explains the mechanisms of computation of variables that are used in this study. Section 7.2 focuses on the definitions of the *dependent variables* in this study. Two dependent variables of interest in this study are identified: (i) the market valuation of the firm as proxied by Tobin's  $q$ ; and (ii) the dividend payout ratio of the firms. Section 7.3 presents the *independent variables* of the various models. These independent variables (also known as explanatory variables) include the corporate governance disclosure score (CGDscore), board size, director ownership, and the splitting of the dual roles of Chairman and CEO of the sample firms. Section 7.4 introduces the *control variables* of the models. These control variables are selected from the previous literature on corporate governance research studies, such as proxy for firm size, return on equity, profitability, earnings, leverage, sales growth, and dual listing, which are shown to have impact on the dependent variables (i.e., market value and dividend payouts) of this study. The definitions and computations of all these variables will be explained. Section 7.5 concludes the chapter with a summary.

### 7.2 Estimation of Dependent Variables

This thesis is a study of the effect of voluntary disclosure of corporate governance (CG) practices by a firm on its market valuation. The impact of the voluntary CG disclosure on the dividend payout of a firm is also another area of research in this study. The empirical models are constructed with a view to estimating the effects of a firm's voluntary CG disclosure on its market valuation and its dividend payouts. Accordingly, two dependent variables are going to be estimated in this study, namely:

- 1) the market valuation of the firm as proxied by Tobin's  $q$ ;
- 2) the dividend payout ratio of the firms.

These two dependent variables are discussed in sub-section 7.2.1 and sub-section 7.2.2 respectively.

### **7.2.1 Estimation of market valuation**

According to the Efficient Market Hypothesis (EMH), the market value of a firm is reflected in the market price of the shares of the firm if the capital market is efficient at the strong or semi-strong form. This study assumes that the stock market of Hong Kong is at least a semi-strong form efficient market, which implies that all publicly available information that are related to a firm will be incorporated and reflected in the share prices of the firm immediately, when the news reach the market.

Market value of a firm is defined in this study as the number of ordinary shares issued by the firm multiplied by the share price. As the share price fluctuates from day to day, the market value of a firm will vary similarly, depending on the amount of information arriving at the market. While the financial information about a firm may be made available to the market as financial news, the non-financial information about the firm's CG practices is mainly disclosed to the public via the firm's annual report, which is released in full version approximately three months after the end of the firm's fiscal year. Hence, for the purpose of this study, the market value of the firm is computed with reference to the closing share price of the firm as at the date of release of the *full version* of the annual report.

The closing share price as at the release date of the full version of the annual report sent to the shareholders is usually different from that as at the release date of the *summarized operating results* for the firm. Like similar practice of many firms in other stock markets, listed firms in Hong Kong usually announce their operating results, mainly about their financial performance in a summary format to the market (i.e., when the firms communicate to the Hong Kong Stock Exchange) at least two business working days before they release the full set of annual report to their shareholders and the public (to allow adequate time for mailing). Should there be any price change due to the unanticipated information about the financial performance of the firm, a semi-strong efficiency market such as Hong Kong is expected to impound the news and adjust the share price of the firm's stock immediately. Hence, at the date of release of the full annual report, any unanticipated price information due to financial disclosure will already be

reflected. On that date of release of the full annual report, the changes of the firm's market value, if any, are presumed to be attributable to the disclosure of non-financial information (such as the firm's CG practices) because the firm discloses such information publicly only in the full version rather than the summarized version. The general public can only come to know about a firm's CG practices and assess the firm's CG conditions as at that date, not as at the date of the end of the fiscal year. Since the focus of this study is on the firm's disclosure of CG practices, which is essentially non-financial rather than financial information, any spurious effects due to the financial performance of the firm is expected to have been fully reflected in the share price by the time the full set of annual report is made available to the public at large.<sup>1</sup>

Market value of a firm needs to be scaled by a number of factors in order to facilitate proper comparisons on equal bases across firms of different sizes, industry sectors, and business natures. Instead of the market value *per se*, researchers generally use Tobin's  $q$  to proxy for a firm's market valuation. This study follows similar approach. Specifically, the definition of Tobin's  $q$  in this study follows previous studies by Demsetz and Lehn (1985), Morck, Shleifer, and Vishny (1988), McConnell and Servaes (1990), Kaplan and Zingales (1997), Gompers, Ishii, and Metrick (2003), Cremers and Nair (2005), and Durnev and Kim (2005). Their definition of Tobin's  $q$  is as follows:

$$q = \frac{\text{Total assets} + \text{market value of equity} - \text{book value of equity} - \text{deferred tax}}{\text{Total assets}}$$

The source of information for the computation of  $q$  is Datastream. Except for the market value of equity, which is stated as at the annual report release date, all other accounting measures such as total assets, book value of equity, and deferred tax are stated as at the end of the firm's fiscal year end.

In Datastream, the market value is defined as follows:

“Market value on Datastream is the share price multiplied by the number of ordinary shares in issue. The amount in issue is updated whenever new tranches of stock are issued or after a capital change.

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<sup>1</sup> It may be argued that, from time to time, a firm may have released non-financial information (such as information about its CG practices) to the market through channels other than its annual report. Though this may be true, there is no commonly accepted evidence that all these channels may reach all investors at the same time. Therefore, it is likely that some outside investors may know about a firm's CG practices later than other investors. It is assumed that such timing difference in investor cognition about a firm's CG will be eliminated once the firm's annual report is made available to the public. This assumption is one of the limitations of this study.

- For companies with more than one class of equity capital, the market value is expressed according to the individual issue.
- Market value is displayed in millions of units of local currency.”

The annual report release date is based on the report date as recorded on the website of the Hong Kong Exchange. A summary of the annual report release dates of the sample firms in this study is included in **Appendix 1** to this thesis.

In addition to the components of Tobin’s  $q$ , other accounting performance information is also sourced from Datastream. Some variables are directly obtained from Datastream, but other variables need to be computed from raw data. For example, a firm’s leverage is defined as the percentage of a firm’s total debt to its book value of total equity. Leverage by itself is not available from Datastream but the two components, total debt and book value of equity, are. Similarly, dividend payout is defined as the dividend per share (DPS) expressed as a percentage of a firm’s earnings per share (EPS), both of which are available from Datastream. In the event where the firm’s annual report is expressed in denomination of U.S. dollars, the account values are converted into equivalent Hong Kong dollars by the official exchange rate US\$1 = HK\$7.78.<sup>2</sup> Table 7.1 below summarizes the names of the variables to be used in this study and their corresponding Datatype Mnemonics from Datastream:

**Table 7.1 Variable names and the source of information**

Item	Datastream Code/ Datatype Mnemonic
Total assets	392 (WC02999)
Market Value of Equity	MV (as at Annual Report disclosed date)
Book Value of Equity	WC03501
Deferred Tax	311 (WC03263)
Total Debt	1301
Return on Equity	1506 (WC08301)
Pre-tax Profit Margin%	716 (WC08321)
Research & Development <sup>3</sup>	119 (WC01201)
Total Sales	104 (WC01001)
Dividend Per Share	DPSF
Earnings Per Share	EPS

<sup>2</sup> The Hong Kong dollar has been officially pegged to U.S. dollar at the rate US\$1 = HK\$7.78 since 1983.

<sup>3</sup> Some researchers incorporate the expenditure on Research & Development (R&D) by a firm in the computation of a firm’s Tobin’s  $q$  but most researchers will ignore it if it is small and insignificant compared to a firm’s total assets. In Hong Kong listed firms, R& D expenditure is low and is seldom reported. Therefore, R & D expenditure is not included in the computation of Tobin’s  $q$  for this study.



### 7.2.2 Dividend payout ratio

In the U.S. and most other developed economies, dividends are taxed at a higher rate than capital gains (LLSV, 2000b; Grullon and Michaely, 2002). For instance, in the U.S., Grullon and Michaely state that, by the end of 2001, there was a gap between the top marginal rate of tax on ordinary income and the marginal rate on capital gains. The top marginal rate on ordinary income was 39.6% but the top marginal rate on long-term capital gains was only 20%. Therefore, dividends are less valuable than capital gains to the common investors because capital gains are taxed at more favourable rates than ordinary income (*ibid*, 2002, p. 1650). Yet, there are always debates as to why firms pay dividends.

There are a number of theories dealing with the identification of the common determinants of corporate dividend policy such as the tax preference theory, signalling theory, behavioural theory, and agency theory, etc (Baker and Powell, 2000). These studies have identified that profitability, firm size, growth opportunities, and leverage would affect the likelihood of paying dividends (e.g., Fama and French, 2001; Benito and Young, 2001; von Eije and Megginson, 2008). In a survey of 603 NYSE-listed firms that had paid cash dividends at least once during the period 1994-1995, Baker and Powell (2000) find that the five major considerations for setting the level of dividends are: (i) the level of current and expected future earnings; (ii) the pattern or continuity of past dividends; (iii) the motivation to maintain or increase the stock price of a firm; (iv) the concern for disseminating a false signal to investors in case of a change in dividends; and (v) the stability of cash flows.

Denis and Osobov (2008) summarize the previous studies by various finance scholars on the determinants of dividend policy into four main theories which are (i) the signalling theory (Lintner, 1956; Miller and Rock, 1985); (ii) clientele theory (Bajaj and Vijh, 1990; Allen and Michaely, 2003); (iii) catering theory (Baker and Wurgler, 2004); and (iv) the life-cycle theory (Fama and French, 2001; Grullon, Michaely and Swaminathan, 2002; DeAngelo and DeAngelo, 2006).

*The Signalling theory* proposes that any changes in the level of dividend payout serve as a signal to the outsiders by the insiders about the future prospects of a firm. Lintner (1956) puts forth a behavioural partial adjustment model which states that managers would prefer a stable dividend policy, and would smooth dividends in the short run to avoid frequent

changes with the aim to minimize adverse stockholder reactions. Empirical work by Fama and Babiak (1968), and Fama (1974), support Lintner's view that managers prefer consistency in dividend payout, and that managers are reluctant to increase dividends to a level that cannot be sustainable.

*Clientele theorists* of dividends assume that investors can satisfy their demand for dividends while still achieving suitable levels of diversification. Investors are heterogeneous and they have different demands for dividends. Some investors may, for institutional or tax reasons, prefer dividends to capital gains (Black and Scholes, 1974). Firms would therefore satisfy demands of these clienteles until, at the margin, no firm could increase its value by changing its dividend payout. Pettit (1977) explains that investors have a tendency to concentrate their portfolios on certain types of dividend-paying securities in an effort to reduce transaction costs and differential tax rates. Though important this clientele effect is, its influence on the investor's portfolio decision is "at the margin" (Pettit, 1977, p. 420; Bajaj and Vijh, 1990, p. 194).

*The Catering theory* of dividends suggests that the propensity to pay dividends can be explained by changes in investor sentiment toward dividend-paying stocks. Baker and Wurgler (2004) hypothesize that investors have a time-varying demand for dividend-paying stocks for either psychological or institutional reasons. Managers rationally cater to investors' demand for dividends by paying dividends when investors place a valuation premium on dividend-paying firms. Managers do not pay dividends where such valuation premium on dividend payers ceases to exist. Baker and Wurgler (2004) conclude that dividends are highly relevant to share price, but in different directions at different times. They state that managers cater to time-varying investor demand in an effort to maximize current share prices.

*The Life-cycle theory* predicts that firms optimally alter dividends through time (i.e., through the firm's life-cycle stages) in response to the evolution of their opportunity set (DeAngelo and DeAngelo, 2006). Firms pay few dividends in their early years because their investment opportunities exceed their internally generated capital. In later years, internal funds exceed investment opportunities so firms optimally pay out the excess funds to mitigate the free cashflows problem as suggested by Fama and French (2001).

While this study does not attempt to investigate the rationale for firms to pay dividends, it contributes to the dividend policy literature by testing whether a firm's voluntary disclosure of CG practices would mitigate the level of dividend payouts. The arguments for this empirical testing are based on the agency models of dividends hypothesis proposed by LLSV (2000b) as will be discussed in Chapter 8. The manager of a firm would like to establish a reputation for treating all capital suppliers fairly, so that when investment opportunities arise the manager can have access to the capital market to raise funds at competitive rates. LLSV (2000b) argue that, in a weak legal protection regime for minority shareholders, paying dividends is one way to establish such a reputation. This thesis tests whether the level of a firm's voluntary disclosure of its CG practices would be an alternative way to establish a similar reputation, under the business environment where a prevalence of predominant share-ownership undermines the legal protection of investor protection, while controlling for profitability, growth opportunities, and leverage.

Hong Kong provides an ideal place for the test because, in Hong Kong, there is no tax levied on either dividends or capital gains. Except for the minor differences in transaction cost, there is effectively no taxation difference to receive a return on investment in terms of capital gains or dividend income to the investors.

In this study, the dividend payout ratio is computed as follows:

$$\text{Dividend payout ratio (\%)} = \frac{\text{Dividend per share} \times 100}{\text{Earnings per share}}$$

Both the dividend per share and earnings per share are obtained from Datastream as at the end of the firm's fiscal year. The Datastream codes for these 2 items are DPS and EPS respectively (as reported earlier in Section 7.2.1). In Datastream, the definition of DPS is:

“The dividend per share as published in the last company accounts, and fully adjusted for capital changes. It is given in prime units of local currency, except for the UK where the figure is in pence per share.”

As for EPS, the definition is:

“This is the earnings per share figure derived from the last published company accounts (or preliminary figures when these are the latest), and adjusted for subsequent capital changes. It is shown in prime units of local currency, except for the UK where it is shown in pence.”

In this study, the dividend payout ratio is defined as dividend per share (DPS) divided by earnings per share (EPS), and is expressed as a percentage. By default, it requires the denominator, EPS, to be positive. However, in the event that some firms decided to pay dividends while suffering a loss (i.e., a negative EPS), the dividend payout ratio would become negative, which does not make analytical sense in the empirical models of this study. Under such circumstances, the dividend payout ratio will be set to 100% so as to differentiate these special firms from those that did not pay any dividends at all due to a loss (i.e., dividend payout = 0). From the information perspective, firms that insist on paying dividends (albeit a token sum) during negative earnings periods are no different from the firms that pay out all its earnings as dividends to the shareholders because, in both cases, the firms would not keep any retained earnings for that year. In that sense, the managers are also giving a signal to the market that they are confident that such a negative EPS might be a temporary phenomenon. Out of total 258 firm-years, there are 17 cases of negative-EPS-dividend-paying incidents (i.e., 6.6%).

### 7.3 Estimation of Independent variables

As mentioned in Section 6.2.1, the relationships between firm value and voluntary disclosure of corporate governance are tested in this study. While two dependent variables are to be tested, namely, the firm value (as proxied by Tobin's  $q$ ) and the dividend payout, several independent (or explanatory) variables are employed. These independent variables are selected based on economic reasoning and similar disclosure studies outlined previously in Chapter 2 Literature Review.

In order to determine the impact of corporate governance on a firm's value, outside investors may find it relevant to find a measure that can capture the extent of the voluntary corporate governance disclosure by a firm. A CG disclosure index (or CGD score) is often computed to proxy for the overall state of a firm's corporate governance disclosure (e.g., Gompers, Ishii, and Metrick, 2003; Beiner, Drobetz, Schmid, and Zimmerman, 2006; Black, Jang, and Kim, 2006). Other discrete measurements about a firm's governance practices include: board size, directors' ownership, duality of the roles of the chairman and the chief executive officer (CEO). They will serve as the independent variables to test the hypotheses in this study while controlling for some factors about individual firm's

characteristics (i.e., control variables). Each of them will be discussed in the following subsections.

### 7.3.1 CGDscore

In order to analyze the relationship between the voluntary CG disclosure of a firm and its valuation in this study, the CG disclosure needs to be measured. A disclosure index, CGDscore, is computed for this purpose. This subsection will present the computation process of the CGDscore, which has three sections. Section A introduces the construction of the disclosure score (CGDscore). Section B discusses the weighting mechanism of each aspect of CG that enters into the computation of the CGDscore. Section C explains why the disclosure by listed firms in year 2005 is still considered as voluntary disclosure and why it should be retained in this study.

#### *i) Construction of the disclosure score*

The corporate governance (CG) score is compiled based on the voluntary disclosure in the firm's annual reports in 2003, 2004, and 2005. According to the *Listing Rules* of Hong Kong Exchange (HKEx), firms were required to include a mandatory Corporate Governance Report in their annual reports with fiscal year starting January 2005. The Corporate Governance Report must be issued in accordance with *Appendix 23: Corporate Governance Report*, which includes two main sections: (i) Mandatory Disclosure Requirement; and (ii) Recommended Disclosures. The report should indicate the overall compliance with the provisions of the Code on Corporate Governance Practices (the Code) contained in *Appendix 14: Code on Corporate Governance Practice*. If there are some areas where firms deviate from these codes, the *Listing Rules* require the firms to highlight the deviations and provide explanations for such deviations (copies of the *Listing Rules Appendix 14* (24 pages) and *Appendix 23* (8 pages) can be found at the website of HKEx at [http://www.hkex.com.hk/rule/litrules/appendix\\_14.pdf](http://www.hkex.com.hk/rule/litrules/appendix_14.pdf), and at [http://www.hkex.com.hk/rule/litrules/MB App 23\(E\).pdf](http://www.hkex.com.hk/rule/litrules/MB App 23(E).pdf), respectively).

According to *Appendix 23*, a listed firm (i.e., the listed issuer on the HKEx) has to disclose its corporate governance practices related to nine areas as stipulated in the Mandatory Disclosure Requirement section, each area with sub-requirements of disclosure as stated below:

- (a) corporate governance practices:-

- a1*: a narrative statement of how the listed issuer has applied the principles in the code;
- a2*: a statement as to whether the listed issuer meets the code provisions in the code;
- a3*: if there is any deviation, then details of such deviation.

(b) directors' securities transactions:

- b1*: whether the listed issuer has adopted a model code of conduct (set out in *Appendix 10: Model Code for Securities Transactions by Directors of Listed issuers*) regarding directors' securities transactions on terms no less exacting than the required standard;
- b2*: whether the directors have complied with the Model Code;
- b3*: if there is any non-compliance, then details of such non-compliance and explanation.

(c) board of directors:

- c1*: composition of the board by categories, and number in each category;
- c2*: number of board meeting held in the financial year;
- c3*: individual attendance of each director;
- c4*: a statement of how the board operates;
- c5*: details of non-compliance, if any, and explanation of the remedial step;
- c6*: where an independent director fails to meet one or more of the guidelines as set out in Listing Rule 3.13, reasons why the listed issuer considers him/her to be independent;
- c7*: relationship, if any, among members of the board and in particular, between the chairman and the chief executive officer.

(d) chairman and chief executive officer:

- d1*: the identity of the chairman and chief executive officer;
- d2*: whether the roles of the chairman and chief executive officer are segregated and are not exercised by the same individual.

(e) non-executive directors:

- e1*: the term of appointment of non-executive directors.

(f) remuneration of directors:

- f1*: the role and function of the remuneration committee or the reason(s) for not having a remuneration committee;
- f2*: the composition of the remuneration committee;
- f3*: the number of meetings held by the remuneration committee; and the record of individual attendance of members on a named basis
- f4*: a summary of the work performed by the remuneration committee.

(g) nomination of directors:

- g1*: the role and function of the nomination committee;
- g2*: the composition of the nomination committee; and the identity of the committee chairman;
- g3*: the nomination procedures and the process and criteria adopted to select and recommend candidates for directorship;
- g4*: a summary of work by the nomination committee;
- g5*: the number of meetings held by the nomination committee.

(h) auditors' remuneration:

*h1*: an analysis of remuneration in audit and non-audit services and the fees paid.

(i) audit committee:

*i1*: its role, function, and composition; and the identity of the chairman;

*i2*: the number of meetings held; and the attendance record of individual members;

*i3*: a report of the work performed;

*i4*: details of non-compliance, if any.

Other than these mandatory disclosures, there are four other specified disclosures that are required to be disclosed in the Corporate Governance Report that are not grouped under any heading:

- (a) An acknowledgement from the directors of their responsibility to prepare the accounts; and a statement by the auditors about their reporting responsibilities;
- (b) A report on material uncertainties, if any, in relation to the firm's ability to continue as a going concern;
- (c) A statement of review of the effectiveness of the internal control system by the board; and
- (d) A statement by the audit committee why the board has taken a different view from that of the audit committee regarding the selection, appointment, resignation, or dismissal of external auditors.

Other than these mandatory disclosures, a firm is strongly encouraged to include information on the following five areas of Recommended Disclosures:

(a) share interests of senior management:

*a1*: the number of shares held by senior management.

(b) shareholders' rights:

*b1*: the way in which shareholders can convene an extraordinary general meeting;

*b2*: the procedures by which enquiries may be put to the board;

*b3*: the procedures for putting forward proposals at shareholders' meetings with sufficient contact details.

(c) investor relations:

*c1*: any significant changes in the firm's articles of association;

*c2*: details of shareholders by type and aggregate shareholding;

*c3*: details of last shareholders' meeting;

*c4*: indication of important shareholders' dates in the coming financial year; and

*c5*: public float capitalisation as at the end of the financial year.

(d) internal controls:

*d1*: an explanation of how the internal control system is defined;

*d2*: the procedures and internal controls for handling price sensitive information;

*d3*: whether the firm has internal audit function;

*d4*: how often internal controls are reviewed;

*d5*: a statement that the directors have reviewed the effectiveness of the internal control system;

- d6*: criteria to assess the effectiveness of the internal control system;
- d7*: the period which internal control review covers;
- d8*: details of any significant areas of concern which may affect shareholders;
- d9*: significant views or proposals put forward by the audit committee; and
- d10*: where the firm has not conducted an internal control review, an explanation why the firm has not done so;
- d11*: a narrative statement on how the firm has complied with the code provisions as specified in the Code on internal control; and
- d12*: the outcome of the internal control review on an annual basis if the firm does not have an internal audit function.

(e) management functions:

- e1*: the division of responsibility between the board and management.

It can be seen that, based on these categories and each sub-requirement, a single-barrel question can be raised with a possible answer ‘Yes’, ‘No’, or ‘Not Applicable’. When there are joint requirements stated by a conjuncture “and”, the requirements are broken up into separate questions. Thus a total of 66 single-barrel questions are derived therein to form a CG disclosure checklist (a copy of the checklist is included in the **Appendix 2** of this thesis).

This disclosure checklist is used to match the information disclosed in all non-financial sections of the annual reports. Specifically, these sections include the Contents, Highlights of Company Performance, Corporate Information, Chairman’s Report, Operation Review, Business Review, Bibliography of Directors and Senior Executives, Directors’ Report, Corporate Governance Report, Auditors’ Report, and Investor Relations. Should the information provided in those sections be inadequate to answer fully the questions on the disclosure checklist, the Notes to the Accounts and Social Responsibility Report sections are also reviewed to look for any missing information.

A score of ‘1’ is assigned to each question if the answer is ‘Yes’, and ‘0’ to the answer of ‘No’ or ‘Not Applicable’. Then the total of the ‘Yes’ answer is summed up, to be scaled by the total of applicable questions (i.e., 66 net of the total of ‘Not Applicable’ answers). The ratio is then expressed in percentage to arrive at the composite disclosure index CGDscore. After filling the checklists and computing the CGDscores, 10% of the checked results were randomly selected and verified by a third person to see if any errors of coding or mis-interpretation of the disclosed information were present. A consistency check was carried out when the raw data were input into an EXCEL spreadsheet so that any irregularities/ unsupported extreme values were rectified.



It should be pointed out that the composite index CGDscore is only capable of capturing the *disclosure* of the CG practices, not the *quality* of the individual CG practice. For example, if Firm A disclosed that it had three independent non-executive directors (INEDs) sitting on the board of directors, it would have the same disclosure score (i.e., 1) as Firm B that disclosed it had six INEDs. However, if Firm A, in addition to the number of INEDs, had also disclosed the number of board meetings that these directors attended whilst Firm B had not disclosed the same, then Firm A would have a higher CGDscore than Firm B because Firm A had disclosed more *aspects* of its CG practice. In practice, Firm A and Firm B could have in fact maintained similar quality in their CG, because presumably the board meetings had been convened with all the directors present. If not, the quorum would ensure the minimum number of directors to be present so as to permit an effective board meeting to take place. Nevertheless, the CGDscore, which is a composite index intended to record objectively the CG practices that a firm *voluntarily* discloses, does not purport to reflect *the quality* or the *state* of the CG of the firm<sup>4</sup>. This is one of the limitations of this study.

#### ii) Weighting

Because every answer carries a score of “1” only, the CGDscore so compiled is an unweighted metric, with a possible range of values 0~100. The higher the CGDscore is, the more disclosure a firm has voluntarily provided in its annual reports.

Equal weighting is assigned to each answer to the single-barrel question. This has two advantages: (i) it is transparent and easily reproducible; and (ii) no assumption is made about the efficacy or wealth effects of any corporate governance provisions (Gompers, Ishii and Metrick, 2003). Other reasons for equal weighting are that:

- (1) there is so far a lack of a theoretical basis to assign weights which would vary from user to user (Black, Jang, and Kim, 2006);
- (2) users of disclosed information may have their own preferences, hence may attach different weightings to the various items of disclosure which may not be common to all others even for similar items (Chang, Most and Brain, 1983; Meek, Roberts, and Gray, 1995);
- (3) unweighted scores have been used in other empirical studies (Cooke, 1989; Ahmed and Nicholls, 1994; Meek, Roberts, and Gray, 1995; Chau and Gray, 2002); and

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<sup>4</sup> To evaluate the quality of a firm's CG, the researcher would have had to participate in all the decision-making processes of the firm that are related to all investors, observe how the decisions are being made, and to assess whether a 'good' governance practise has been applied. This is almost infeasible in all practical sense.

- (4) empirical evidence has suggested that a compound (i.e., weighted) disclosure index may yield a lower collective explanatory power in  $R^2$  than a simple (unweighted) disclosure index (Robbins and Austin, 1986); and there is also empirical evidence that shows a simple unweighted disclosure index has equivalent explanatory power to a weighted one (Chow and Wong-Boren, 1987).

In short, an equal weighted index is simple, intuitive, and less prone to measurement error. It is not affected by the problem of subjectivity in assigning weights to a multitude of governance provisions in constructing a governance index.

*iii) Rationale for including disclosure in fiscal year 2005 as voluntary disclosure*

While the CG disclosures in the annual reports for fiscal years 2003 and 2004 made by the listed firms are completely voluntary, there are also arguments to support that the disclosures made in fiscal year 2005 should also be classified as voluntary despite the promulgation of the new *Listing Rules*. During the first year of implementation of the *Rules*, the listed firms (or the issuers) were allowed great flexibility in compliance, as stated in *Appendix 14* of the *Listing Rules*:

“Issuers are expected to comply with, but may choose to deviate from, the code provisions. The recommended best practices are for guidance only. Issuers may also devise their own code on corporate governance practices on such terms as they may consider appropriate.”

“Issuer must state whether they have complied with the code provisions set out in this Code (i.e., *Appendix 14*) for the relevant accounting period in their interim reports and annual reports. However, issuers are permitted *not* to comply with the recommended best practices in full provided that they explain the reasons.”

Similarly, *Appendix 23* also sets out a list of recommended disclosure for the issuers’ reference. They are not mandatory but intended to be areas that the issuers may comment on in their Corporate Governance Report. These areas include share interests of senior management, shareholders’ rights, investor relations, and internal controls and management functions.

The HKEx has therefore given much leeway and autonomy to the issuers in deciding on the corporate governance structure of the firms. What is absolutely mandatory for disclosure is that “issuer must state whether they have complied with the code provisions set out in *Appendix 14* for the relevant accounting period in their interim reports and annual reports”. Listed firms are *de facto* given the option to decide if the CG structures and practices stipulated in the revised *Listing Rules* will be adopted or otherwise. In the

process of examining the annual reports for 2005, it is found that there is a significant portion of firms which did not comply with the code provision that the roles of the Chairman and the CEO should be split. The management of these firms argued that splitting the roles would not be in the interest of the firm's long-term development. Another area of non-compliance is found in the disclosure of the Internal Control System. Many issuers did not disclose how the Internal Control System had been set up or implemented during their fiscal year 2005, despite the concession that the HKEx had agreed earlier on to postpone the effective date on disclosure of the Internal Control System until July 2005. A third area of major deviation from the *Listing Rules* requirements is the setting up of the Nomination Committee or the Remuneration Committee. Many issuers only set up the committee in early 2006, i.e., *after* the 2005 fiscal year end but before the annual report release date. They stated in their annual reports for 2005 that such committees had been set up, but no meetings had been held for that fiscal year. In effect, the firms did not implement the CG practices in 2005.

As the firms could have opted not to implement the CG mechanisms by stating the reason for non-compliance, this study will consider those firms that adopt the CG mechanisms and practices in 2005 as to have done it on a voluntary basis. The fiscal year of 2005 is therefore included for study, with the focus of attention on whether the firms have implemented any CG mechanisms and actually practised them. Consequently, the data collected for this study are for three consecutive fiscal years from 2003 to 2005.

### **7.3.2 Board size**

Board size is one of the independent variables to be employed in the empirical analyses of the models in this study (model specifications will be discussed in Chapter 8). It refers to the total number of directors sitting on the board. Previous literature has shown two board-size effects for large public firms: (i) increased problems of communication and coordination as group size increases, and (ii) decreased ability of large boards to control management (Lipton and Lorsch, 1992; Jensen, 1993). Yermack (1996) find empirical evidence from U.S. large firms that board size and firm market value (as represented by Tobin's *q*) are inversely related. However, board *size* remains quite stable over time with little sensitivity to performance, whereas the rate of director *turnover* increases following poor performance.

On the other hand, Eisenberg, Sundgren, and Wells (1998) find empirical evidence from 900 small boards and small firms in the U.S. to support a negative correlation between board size and profitability. Their findings suggest that board-size effects may have different roots in small, closely held firms than in large firms.

Nevertheless, board size is often accepted as endogenously determined because the board of director is an institution that has “arisen endogenously in response to the agency problem inherent in governing any organization” (Hermalin and Weisbach, 2003). Such a *monitoring hypothesis* argument is not supported by a panel study of all U.S. industrial firms by Boone, Field, Karpoff, and Raheja (BFKR, 2007) on board size development over a 10-year span since the firms’ initial public offerings. The empirical results of BFKR’s study affirm that board size (and composition) is shaped by a broad combination of firm-specific and managerial characteristics. Most boards are tailored-made to suit their unique competitive environment. BFKR’s findings support the *scope of operations hypothesis* as proposed by Fama and Jensen (1983b), Lehn, Patro, and Zhao (2005), and Coles, Daniel, and Naveen (2008), who claim that board structure is driven by the scope and complexity of the firm’s operation.

If board size is not endogenously determined, then it qualifies very well as an independent variable in explaining the relationship between corporate governance disclosure and a firm’s value.

### **7.3.3 Directors’ ownership**

Directors’ ownership refers to the percentage of equity collectively owned by members of the board of directors, including their family members, as disclosed in the annual reports. The non-linear relationship between firm value and managerial ownership (or directors’ ownership in this study) has been well documented (Morck, Shleifer, and Vishny, 1988; McConnell and Servaes, 1990; Hermalin and Weisbach, 1991). In prior literature, firm value has been found to increase with managerial holdings for very low levels of managerial ownership, which lends support to the *alignment of interest* argument by Jensen and Meckling (1976). However, when managerial holdings reach a higher level, a fall in firm value is observed with further increases in holding by management due to the agency problem (Morck, Shleifer, and Vishny, 1988; Hermalin and Weisbach, 1991). This is often explained by the *entrenchment* argument, which suggests that entrenched managers

may pursue their own self-interests rather than the interests of the shareholders as a whole. At the same time, the entrenched managers cannot be easily evicted from the firm due to a lack of consensus efforts by the outside investors. A high agency cost is therefore likely to occur. At this stage, outside investors need information to assure themselves that their interests will be treated equally and protected by the insiders (i.e., the management). Any voluntary disclosure of corporate governance by the insiders can be expected to be useful to reinstall outsiders' confidence. Hence, insiders' ownership is a factor that is likely to affect firm valuation.

Though some researchers argue that the level of managerial ownership is determined endogenously in equilibrium (Demsetz and Lehn, 1985; Cho, 1998; Himmelberg, Hubbard and Palia, 1999), recent researchers using advanced econometric models find empirical evidence that managerial ownership in the U.K. has a significant impact on firm value (Short and Keasey, 1999; Davis, Hillier and McColgan, 2005), and that there are more turning points in the non-linear relationship between the level of ownership and firm value. Nevertheless, there is little theoretical basis on which the individual turning points can be precisely determined.

The director ownership percentage data in this study are hand collected from the annual reports for each of the 3-year period from 2003 to 2005. Since the ownership percentage is a ratio measurement, it can vary continuously between 0 and 100% and can provide a high level of flexibility in forming sub-categories of different groups of ownership level (e.g., low, medium, and predominant) for further analyses.

#### **7.3.4 Split roles of Chairman and CEO**

Shareholder activists generally consider whether or not the roles of a Chairman and the Chief Executive Officer (CEO) are split as a key function of checks and balances imposed on the autonomy of the managers of the firm (Wahal, 1996). Cadbury (1992, p. 21, para. 4.9) recommends that the two roles of the Chairman of the board and the CEO be separated in the quoted companies in the U.K. Jensen (1993) articulates the potential benefits of separation of the two roles as "the function of the Chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO. Clearly the CEO cannot perform this function apart from his or her personal interest." It follows that for the board to be effective, "it is important to separate the CEO and Chairman positions"

(*ibid*, 1993, p.36). From the corporate governance point of view, the roles of the two titles should be split, otherwise the Chairman/CEO's duality will allow the CEO to exert dominant power over the decisions and practices of the board (Booth, Cornett, and Tehranian, 2002).

However, Brickley, Coles, and Jarrell (1997) challenge this view. Based on a sample of 737 firms from the 1989 *Forbes* survey, they find that the separation of the titles of the Chairman and CEO may not be what it seems: that almost no major firm in the U.S. as reported in that survey had an *independent outsider* as chairman. The Chairmen are almost always the people with detailed knowledge of the firm and relatively high equity ownership. Furthermore, they find evidence to suggest that firms employ the title of chairman as a reward for CEOs who perform well during a probationary period – a 'passing-of-the-baton' succession process rather than a monitoring function. Most critically, they find no empirical evidence that combining the two roles into one person is associated with inferior accounting performance or market returns.

The fact that the chairperson is a knowledgeable insider, rather than an independent outsider, is a common phenomenon to firms in Asian countries. In Asia, especially in Hong Kong where family businesses abound, insiders typically dominate boards of directors; and the controlling shareholders are often founders of the firms (Claessens, Djankov, and Lang, 2000; Claessens and Fan, 2002; Chen, 2005). Nevertheless, investors may not necessarily be worse off because they would discount the stocks according to the perceived corporate governance issue (Claessens and Fan, 2002), and are willing to pay a premium for firms that protect shareholder rights and engage in open disclosure (Klein, Shapiro, and Young, 2005). Since the disclosure of the duality of Chairman/CEO is stipulated by the *Listing Rules* in Hong Kong, such information can be expected to be useful to the investors to shape or modify their perception about the firm value. The disclosure of the split roles of the Chairman/CEO is therefore an independent variable in the analysis of the relationship between the voluntary corporate governance disclosure and firm value.

To operationalise this criterion, a dummy variable *SplitRole* is employed to denote whether a split role for the chairperson and the CEO is performed by separate persons. If the segregate roles are borne by separate individuals, the dummy variable takes on a value '1', otherwise '0'. This is in line with the computation of the corporate governance disclosure

score (CGDscore) when the split of Chairman's and CEO's roles is advocated by the *Listing Rules*. However, it should be noted that, in some firms, although the titles of Chairman and CEO are separate, the office bearer's name appears the same. That is, they are listed as separate titles in the annual report but are performed by the same individual. In that case, both the CGDscore and the SplitRole will take on a value '0' to denote the *de facto* state of this CG provision, i.e., there was no splitting between the roles of Chairman and CEO even though their titles appear to be split. The reason of using two measures to capture the same CG provision is that the CGDscore reports the fact that this CG provision is being disclosed; whilst the SplitRole reports the CG provision is being practised.<sup>5</sup>

## 7.4 Control variables

Control variables are the explanatory variables in an analytical model that are specially chosen (i.e., they are not allowed to vary freely) in order to study how the dependent variable behaves under set conditions (Francis, 1990). These variables are chosen because they have been previously established (or known) to have an impact on the dependent variable, but their estimated relationship with the dependent variable is not the primary focus of the study in that model. Omission of controlled variables from a model may give rise to a biased relationship, and may often lead to an unduly low coefficient of determination  $R^2$  for the regression model.

Previous empirical studies on disclosure and valuation of firms have suggested the use of control variables. For instance, Khanna, Palepu and Srinivasan (2004) suggest that firm size, firm performance, analyst following, and country legal origin can have impact on the market valuation of a firm. Other studies suggest that market dominance, owners' equity, leverage, sales growth, and dual listing should also be considered (e.g., Mitton, 2002; Eng and Mak, 2003; Hutchison and Gul, 2004). Following their recommendations, this study employs firm size (as proxied by the sales income of a firm), ROE (return on equity), sales growth, the size of owners' equity, and the debt ratio as the control variables. They are discussed in turn in the following subsections.

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<sup>5</sup> The direct link between the CGDscore and SplitRole may be one of the factors that lead to high correlation between these two variables. See the descriptive statistics in Chapter 9.

### 7.4.1 Firm size

In the corporate disclosure literature, firm size is one of the main corporate characteristics that have been found to affect a firm's extent of disclosure (Cerf, 1961; Singhvi and Desai, 1971; Choi, 1973; Foster, 1986; Chow and Wong-Boren, 1987; Cooke, 1989a, 1992; Meek, Roberts, and Gray, 1995; Eng and Mak, 2003). Generally, large firms disclose more information than small ones because of their characteristics such as lower information production costs, higher complexity in business operation, wider ownership base, greater liability to agency costs, and more susceptibility to political costs (Jensen and Meckling, 1976; Watts and Zimmerman, 1986) as previously discussed in the Chapter 4 of this thesis.

The information economics literature also suggests that firm size has an impact on the information set available to outsiders. Large firms tend to be more diversified, more complex, and have larger information set than do small firms in terms of their market development, sales sustainability, and business risks (Meek, Roberts, and Gray, 1995). Firm size is computed as the logarithm of net sales in this study. It is often regarded as a proxy for the amount of information available to outside investors (Cheng and Shiu, 2007), or a proxy for informational asymmetries between insiders and the capital markets (Rajan and Zingales, 1995). Finance literature has often suggested that firms of different sizes will opt for different disclosure strategies to reduce such information asymmetries. Based on this information, investors adjust their assessment of the firm's future profitability.

Firm size often helps in explaining disclosure behaviour. As larger firms are likely to face higher public demands for information (Zarzeski, 1996), it seems likely that investors' valuation of the firm will change accordingly, hence there should be different strengths in the disclosure-firm valuation relationship.

Firm size is usually proxied by 3 metrics, namely, market value, total assets, and total sales. In this study, firm size is computed as the logarithm of net sales in HK dollars, which is captured from Datastream file (Datastream code: 104 Total Sales). The reason for using 'Sales Revenue' instead of 'Total Assets' as a proxy for firm size is that one of the dependent variables in this study, Tobin's  $q$ , has 'total assets' as a component in its computation. If Tobin's  $q$  (the left-hand side variable) is regressed on some independent variables with 'total assets' appearing on the right-hand side of the regression, an unjustifiably high score of  $R^2$  will incur. Another benefit of choosing sales revenue to



proxy for firm size is that it is less affected by variations in GAAP than are other common measures of size, such as total assets (Meek, Roberts, and Gray 1995).

The definition of 'Total Sales' of industrial companies (i.e. firms that are not Banks, Insurance or other financial companies) in Datastream is:

**“Net sales or revenues (01001) represent gross sales and other operating revenue less discounts, returns and allowances.”**

It includes, but is not restricted to, franchise sales, consulting fees, service income, royalty income, contracts-in-progress income, licensing and franchise fees, income derived from equipment lease or rental, commissions earned, income from leased departments. It excludes non-operating income, interest income, rental income, dividend income, foreign exchange adjustment, sale of plant, equipment, or investment, etc.

#### **7.4.2 Return on Equity (ROE)**

The rate of return measures the overall performance of a firm and is usually considered as an indicator of good management (Singhvi & Desai, 1971). It is generally defined as a ratio of net profit to net worth. If the rate of return is high, the managers may disclose detailed financial information in order to support the continuance of their positions and compensations. If, however, the rate of return is low, the managers may disclose less information in order to cover up the reasons for losses or declining profits (Singhvi & Desai, 1971; Bradury, 1992; Eng and Mak, 2003).

One of the measures of a firm's rate of return is the return on equity (ROE), defined in Datastream as follows and will be adopted in this study:

$$\frac{(\text{Net Income before Preferred Dividends} - \text{Preferred Dividend Requirement}) \times 100}{\text{Last Year's Common Equity}}$$

The ROE is also one of the factors that may have an impact of a firm's disclosure quality (Singhvi & Desai, 1971). Less profitable firms (as measured either by a lower ROE or a lower earnings margin) tend to disclose less information. Conversely, more profitable firms (high ROE) have been found to disclose more about their voluntary disclosures in

their annual reports (Haniffa and Cooke, 2002), as has been posited by the signalling hypothesis (Ross, 1979).

As the ROE is defined as a ratio with the firm's equity as the denominator, any negative equity (due to restructuring, for example) recorded by a firm will lead to a negative ROE, which has not the same meaning as making a loss as a negative ROE may seem to suggest. Therefore, any entry in the Datastream data set that carries a negative ROE will be cross-checked with the firm's equity to see if a negative equity is present. If there is a negative equity, the case will be deleted from the sample.

### **7.4.3 Leverage (Debt /Total Assets ratio)**

Jensen and Meckling (1976), Chow and Wong-Boren (1987), Meek, Roberts and Gray (1995) observe that agency costs are higher for firms with proportionally more debt in their capital structures, suggesting a positive relationship between the extent of voluntary disclosure and leverage. With increased leverage, there are increased potential for wealth transfers from bondholders to shareholders, thus calling for more voluntary disclosures on the part of the managers (Smith and Warner, 1979).

On the other hand, Zarzeski (1996) argues that, if firms have higher debt ratios, it is likely that they share more private information with their creditors. Highly leveraged firms are therefore likely to have developed banking relationships and interlocking corporate ownerships as alternate capital sources to public ownership. Conversely, firms with lower debt have a higher percentage of stock ownership, which could encourage investor demand for more voluntary disclosure. Zarzeski finds empirically a negative relationship between the debt ratio and investor-oriented disclosure in her cross-country sample (256 firms) as well as in her sub-sample of Hong Kong firms (29 firms).

In this study, leverage of a firm is defined as the Total Debt (Datastream Code 1301) divided by the sum of the firm's Book Value of Equity (Datastream Code WC03501) and Total Debt (Datastream Code 1301). The definition of Total Debt is:

“Total debt represents all interest bearing and capitalized lease obligations. It is the sum of long and short term debt.”

The Book Value of Equity (**Common Equity** 03501) is defined as:

“Common equity represents common shareholders’ investment in a company.”

It includes common stock value, retained earnings, capital surplus, capital stock premium. It excludes common treasury stocks, preferred stock, and any accumulated unpaid preferred dividends. For consistency and the purpose of further ratio analyses that may require equity as a denominator, any firms that have a negative book value of equity (e.g., a leverage buy-out) will be deleted from the sample.

#### **7.4.4 Sales growth**

Growth firms have greater information asymmetry and agency costs (Smith and Watts, 1992; Gaver and Gaver, 1993). For growth firms, information asymmetry arises between managers and shareholders because managers have private information about the future value of investments not readily accessible to outsiders (Hutchison and Gul, 2004). On the other hand, the preference for equity over debt financing in growth firms may help alleviate some of the potential conflicts between managers and shareholders, because equity financing is less restrictive on managers than covenant-based debt (Skinner, 1993). It follows that managers in growth firms may behave differently in voluntary disclosures in their corporate governance practices from those in non-growth firms. Nevertheless, Eng and Mak (2003) find a negative though not significant relationship between a firm’s growth and the voluntary disclosure on its corporate governance information in their study.

In this study, growth is proxied by the increase in Total Sales in percentage over the previous fiscal year. The definition is as follows:

$$\text{Growth} = \frac{[\text{Total Sales in fiscal year } n - \text{Total Sales in fiscal year } (n-1)] \times 100}{\text{Total Sales in fiscal year } (n-1)}$$

Total Sales is obtained from Datastream (code WC01001) with definition as previously stated in Section 7.4.1.

#### **7.4.5 Dual or Multiple listing**

Multiple listed firms are often motivated to disclose differently from single-market listed firms. They have an interest in foreign capital markets since foreign operations are often

financed by foreign capital (Choi and Mueller, 1984; Cooke, 1989a). LLSV (1998) and Johnson, Boone, Breach, and Friedman (2000) argue that accounting standards and regulations play an important part in corporate governance. Mitton (2002) suggests that firms with a listed ADR (American Depositary Receipt) have higher disclosure quality. Reese and Weisbach (2002) suggest that non-US firms choose to cross-list in the U.S. in order to demonstrate to investors that they are providing protection to minority shareholders. It follows that when a firm chooses to be cross-listed, it subjects itself to additional set of disclosure requirements, which non-cross listed firms do not. Therefore, the status of being cross-listed on other country's stock exchanges may affect a firm's voluntary disclosure.

In the sample set of this study, most cross-listed firms obtain an ADR status while only a handful of firms are cross-listed fully either in London or Tokyo Stock Exchanges. Given that an ADR status may often require a firm to comply with an additional set of accounting standards (which may lead to reconciliation of accounts and further scrutiny on the interpretation of, say, accruals), all ADR firms and full cross-listing firms are treated as the same and will be assigned with a dummy variable "1", otherwise "0", in the empirical models.

## 7.5 Summary

This chapter has described the variables that are going to be used in the testing of the empirical models, to be presented in the following chapter. Two dependent variables (Tobin's  $q$  and the Dividend Payout ratio) are discussed, with the construction and the explanations for the use of four independent variables (i.e., CGDscore, Board Size, Directors' Ownership, and Split Roles of Chairman and CEO) and five control variables (i.e., Firm Size, ROE, Leverage, Sales Growth, and Dual Listing) identified. The definitions of these variables are presented and the sources of information for the compilation of these variables are documented. The next chapter, Chapter 8, will focus on the research design, sample selection, and methodology of this study. It will present the sample space of firms and provide a description of the constituent stocks of the SmallCap, MidCap, and LargeCap indices of the Hang Seng Hong Kong Composite Index series, from which the sample firms are drawn. Finally, the empirical models will be specified.

# Chapter 8: Sample Selection, Data Collection, Methodology, and Research Design

## 8.1 Introduction

The aims of this study are to investigate the relationships between a firm's voluntary corporate governance (CG) disclosure, its market valuation, and its dividend payouts. The relationships are to be examined in the context of a strong legal protection regime and with the presence of a predominant shareholder. These relationships are explored by conducting empirical analyses on different groups of Hong Kong listed firms and in terms of market capitalisation. The constituent firms of the Hang Seng Hong Kong Composite Index (HSHKCI), namely, LargeCap, MidCap, and SmallCap firms, are used for this study.

The research questions, hypotheses, and variables have been discussed in chapters 6 and 7. In this chapter, the discussion will focus on the sample selection, data collection, research design and methodology. Specifically, Section 8.2 lays down the justifications for sample selection and expounds on the merits for choosing listed firms in Hong Kong as the sample for this study. Section 8.3 discusses the sample construction in terms of their groupings of market capitalisation. Section 8.4 describes the period of study over which accounting data and market performance data of the sample firms are collected. A breakdown of the total observations for the sample is also provided.

Section 8.5 presents a descriptive account of the cross-listing status of the sampled firms. Cross listing is a factor likely to enhance a firm's CG practices, but the disclosure of such status is not mandatory in the Corporate Governance Report of the annual report of the firm. Section 8.6 describes the data collection of CG information about the firms from their annual reports. It describes the construction of the CG checklist, based on *Appendix 23* of the *HKEx Listing Rules* (2005). The CG checklist is the tool for compiling the CG disclosure score (CGDscore) of the sample firms, which is also elaborated in that section. Section 8.7 explains the research design. The LargeCap (L) firms, MidCap (M) firms, and SmallCap (S) firms from the HSHKCI are grouped into three samples consisting of (i) L+M+S; (ii) L+M; and (iii) S firms. These three samples will provide the sample frame for testing the

empirical models, which are to be specified in the section that follows. Section 8.8 features and explains the models, which are derived from the hypotheses that are stated previously in Chapter 6, with the variables defined in Chapter 7. Section 8.9 provides a summary on the chapter.

## 8.2 Justifications for sample selection

The rationale for selecting Hong Kong firms as the sample for this study has been briefly discussed in Section 1.2 of Chapter 1 of this thesis. The characteristics of Hong Kong firms in terms of their propensity towards predominant ownership have also been described in Section 5.6 of Chapter 5. The current section expatiates on these arguments and enriches them with findings from previous studies to provide support for selecting Hong Kong firms for this study.

There are three major reasons for selecting Hong Kong listed firms as the sample for this study. Firstly, Hong Kong is an international financial centre. Although over 90% of the population in Hong Kong is Chinese, English is one of the official languages in the HKSAR government and is widely used in the business sector. Located on the Pacific Rim in East Asia, Hong Kong has, for many years, been the second largest stock market in Asia by market capitalisation after Tokyo Stock Exchange<sup>1</sup>. It is ranked by international rating agencies as one of the most advanced markets in the region, probably due to the legacy of an Anglo-Saxon common law system (Cheung, Connelly, Limpaphayom, and Zhou, 2007). It also has a reputable and well-developed finance market infrastructure. The accounting standards of Hong Kong listed firms are being harmonized with international standards. There is no restriction on the flows of capital, individuals, or information inside or outside of Hong Kong. Neither dividends nor capital gains are taxable. Compared with other Asian economies, cross listing of firms from outside Hong Kong is made relatively easy. All these characteristics of Hong Kong market provide a suitable setting for testing the hypotheses relating to the effect of voluntary disclosure of CG practices on firm valuation.

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<sup>1</sup> As at the end of 2005, Hong Kong ranked the 8<sup>th</sup> by market capitalization among members of the World Federation of Exchanges (HKEx, *Fact Book* 2005).

Secondly, the classification of listed firms in Hong Kong in terms of market capitalisation by the HSHKCI index provides a comprehensive framework for sample collection. The Hong Kong stock market is currently floated with firms either domiciled in Hong Kong or Mainland China. Since 1964, the Hang Seng Index Company Ltd (HSICO) has been continually providing market index services to the Hong Kong Stock Exchange (HKEx), with the Hang Seng Index (HSI) being the main market index. HSICO has been compiling, publishing, and up-keeping the HSI for many decades. It has accumulated a wealth of experience and credibility in the provision of an unbiased index to measure market sentiments accurately. With more and more China-based corporations floating on the HKEx (i.e., the state-owned enterprises and financial institutions with main business operations in China), it became necessary for HSICO to provide separate geographic indices to reflect the performances of the Hong Kong stock market net of the effect of these China-based companies, which are often characterized with very large capitalisation.

On 3 October 2001, the geographical index series of the Hang Seng Composite Index (HSCI) was launched. It offered investors a more relevant benchmark to gauge the different risk-and-return profiles of listed companies based on the principal markets of business rather than the market for listing of the firms. The stock universe of the HSCI is composed of firms with primary listing on the Main Board of the HKEx. Firms with more than 50% of their sales revenue (or profits, or assets, if more appropriate) derived from mainland China are included in the Hang Seng Mainland Composite Index (HSMCI). Firms with sales revenue derived from Hong Kong and outside Mainland China are included in the Hang Seng Hong Kong Composite Index (HSHKCI). The HSHKCI index excludes all the Chinese state-owned firms whose main business is derived from Mainland China. It is devoid of the undue influence from the China-based stocks and, as such, is a more accurate index of the performance of the Hong Kong domestic market. The HSHKCI is further divided into 3 sub-indices:

- (i) The Hang Seng HK LargeCap Index (HSHKLCI);
- (ii) The Hang Seng HK MidCap Index (HSHKMCI); and
- (iii) The Hang Seng HK SmallCap Index (HSHKSCI).

During September 2005 when the data collection of this study began, the classification criteria for the HSHKLCI (i.e., LargeCap) were based on the top 15

stocks by market capitalisation in the HSHKCI. The HSHKMCI (i.e., MidCap) was based on the market value of firms that ranked from the 16<sup>th</sup> to 50<sup>th</sup> in the HSHKCI, while the HSHKSCI (i.e., SmallCap) was based on those that ranked 51<sup>st</sup> and below till the 90% threshold of the market capitalisation of stocks had been reached. As at September 2005, these three sub-indices comprised 106 firms (or 11%) of a total 934 listed members on the main board of the HKEx, but accounted for 90% of the market capitalisation of all Hong Kong-domiciled firms in 2005 (HKEx *Factbook* 2005).

The constituent companies of these sub-indices hence represent a reliable cross-sectional sample of Hong Kong enterprises. They conduct their business activities under a common law regime that provides a strong, legal, protection for investors (LLSV, 2000). By referring to the three indices of the HSHKCI and their constituent firms, this study is unique in being able to analyse three groups of firms of different market capitalisations both individually and collectively. This differs from most of the previous CG research studies using Hong Kong firms as samples, which used a few top LargeCap firms as representative for all Hong Kong businesses, or did not distinguish the LargeCap corporations from the SmallCap companies (e.g., Chen and Jaggi, 2000; Cheung, Connelly, Limpaphayom and Zhou, 2007).

Thirdly, unlike those state-owned firms domiciled in Mainland China but floated on the HKEx, the constituent firms of the HSHKLCI, HSHKMCI, and HSHKSCI are characterized by the usual presence of a predominant (and often, family) shareholder (Lam, Mok, Cheung, and Yam, 1994; Claessens, Djankov, and Lang, 2000; Chen and Jaggi, 2000; Lins, 2003; Ho, Lam, and Sami, 2004). Such a predominant shareholder very often holds more than 50% equity ownership, thus commanding a decision-making power almost unrivalled on the board of directors. Moreover, the presence of a highly concentrated ownership often leads to the majority shareholders appointing themselves as directors. As a result, the ownership, control, and management of a firm are often vested in the same person or family (Chen and Jaggi, 2000; Ho, Lam, and Sami, 2004). The predominant shareholder is often in charge of the board as well as the day-to-day management activities of the firm. As Ho and Wong (2001) put it, family ownership in Hong Kong firms is often high enough to secure a controlling position that may lead to entrenchment problems. The controlling position is so common that “corporate boards in Hong Kong are



sometimes viewed by international investors simply as a means to approve the wishes of the family shareholders”(ibid, 2001, p. 145).

Corporate governance issues in these Hong Kong-based firms, therefore, are likely to be distinct from those of the state-owned firms, but similar to those firms in other markets wherever a concentrated ownership prevails. A CG report compiled by the credit-rating agency Standard & Poor has already pointed out in 2002 that the main weaknesses in the Hong Kong governance environment are less at the legal and regulatory levels than at the individual firm level. Rather, the family domination of firm’s ownership structure in Hong Kong and the limited – though growing – shareholder activism culture present particular challenges (Standard & Poor’s, 2002). The report points out that having a predominant shareholder of 50% or more equity ownership would often render the market-disciplining mechanisms (such as proxy fights, market for corporate control, and takeovers etc.) ineffective in Hong Kong.<sup>2</sup>

In sum, Hong Kong provides a unique setting to study the voluntary disclosure of CG practices and the valuation of firms. It combines characteristics of both developed and developing economies (Cheung, Connelly, Limpaphayom, and Zhou, 2007). It has concentrated ownership (Claessens, Djankov and Lang, 2000), a predominance of family-owned and -managed firms (Chen and Jaggi, 2000), an Anglo-Saxon common law legal system that provides strong legal protection of minority shareholders (LLSV, 2002), a corporate governance system closely following those adopted in the U.S. and the U.K.(Cheung, Stouraitis and Wong, 2005), a single unitary stock exchange exercising strong regulatory control over the listed firms, and a weak market for corporate control (Cheung, Connelly, Limpaphayom, and Zhou, 2007). It provides an ideal testing ground to investigate how voluntary disclosure and firm valuation are related in a market where family ownership and concentrated shareholdings predominate. Compared with state-owned enterprises, the voluntary CG disclosure behaviour of these predominantly insider-owned firms can be expected to be quite different from those firms whose directors are mainly government ex-officials with nil ownership (or very little stakes in the firms) characterised with uncertain board directorship tenure. A CG disclosure study using Hong Kong firms as samples provides the researcher with the benefit to be able

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<sup>2</sup> Cheung and Shum (1993) report that there was only one successful hostile takeover in Hong Kong during the period 1986 to 1991. They conclude that it was, to a large extent, due to the concentrated ownership structure of Hong Kong listed firms.

to test if a strong legal investor protection is effective to curb the excessive power of a predominant shareholder. A CG study that examines LargeCap, MidCap, and SmallCap firms as separate categories within the same market and legal regime provides added benefits in isolating the effects of CG disclosure on market valuation of a firm, which might be caused by the differences in the firm's market capitalisation, or by other differences in information asymmetry related to insider ownership.

### 8.3 Sample construction

Sample firms in this study are identified from the constituent stocks of the three sub-indices of the Hang Seng HK Composite Index (HSKCI), namely, the HSHKLI for the large capitalisation (LargeCap) firms, the HSHKMI for the medium capitalisation (MidCap) firms, and the HSHKSI for the small capitalisation (SmallCap) firms as at 5<sup>th</sup> September 2005 when the data collection process of this study began. As at that date, there were 106 stocks in the Hang Sang HK Composite Index with the composition as follows:

- 16 stocks<sup>3</sup> in the Hang Seng HK LargeCap Index, covering 80% of the market capitalisation of the HSHKCI.
- 35 stocks in the Hang Seng HK MidCap Index; covering the next 15% of the market capitalisation of the HSHKCI.
- 55 stocks in the Hang Seng HK SmallCap Index; covering the remaining 5% of the market capitalisation of the HSHKCI.

A full list of the names of the 106 HSHKCI constituent stocks as at 5 September 2005 is provided in **Appendix 1**.

For the purpose of this study, the following firms in the HSHKCI are excluded:

- (i) Banking corporations, insurance corporations, financial institutions (e.g., deposit-taking companies); whose accounting definitions on assets, equities, and liabilities are different from non-financial firms. The market performance measure,  $q$ , and the market-to-book ratio, for these financial firms may not be similarly defined as for non-financial firms, hence making

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<sup>3</sup> Swire Pacific 'A' shares (HKEx code: 19) and 'B' shares (HKEx code: 87) are both listed on the HKEx and are constituent stocks of the HSHKLCI. Hence, effectively, there were only 15 companies but 16 stocks in the LargeCap category.

them incomparable with the non-financial firms (Wallace and Naser, 1995). Moreover, financial firms are subject to the monitoring regulations set by the Hong Kong Monetary Authority. The disclosure environments are vastly different from those of non-financial firms. For these reasons, 14 financial firms of the HSHKCI are excluded from this study.

- (ii) In addition, two non-financial firms are excluded from this study: (1) China Resources Peoples Telephone Co. (HKEx Code 331), which was not yet listed in 2003 but was privatised on 28 March 2006, shortly before its results for fiscal year 2005 (year end at December) became available; and (2) Pacific Century Premium Developments Ltd (HKEx Code 432) which changed its fiscal year in 2004, resulting in incompatible comparison of its data with other sample firms.

A total of 90 constituent stocks of the HSHKCI (i.e., Panel A in **Appendix 1**) are identified, representing 89 firms eligible for this study.<sup>4</sup> The distribution of these sample firms, subdivided into three market capitalisation categories according to the HSHKCI sub-indices, is stated in Table 8. 1 below:

**Table 8.1 Number of firms in the sample by market capitalisation**

Market Capitalisation	No. of non-financial firms in the sample
LargeCap	12
MidCap	29
SmallCap	48
Total	89

The stock composition of the LargeCap, MidCap, and SmallCap indices changes from time to time, though not frequently. As already explained in Section 8.2 of this chapter<sup>5</sup>, the set of indexed firms changes according to the market capitalisation of the constituent stocks from time to time. The index preparing company, HSI Co Ltd (HSICO), conducts regular reviews of the performance of these stocks, usually on a half-yearly basis but not on a fixed, pre-announced, date. It replaces the constituent

<sup>4</sup> As per same reason stated in Footnote 3 above.

<sup>5</sup> In regular review by HSICO, any stock with a market capitalisation ranking that falls below the 18<sup>th</sup> position in the HSHKCI will be removed from the HSHKLI, while any stock with ranking above the 12<sup>th</sup> position will be included. Similarly, during the regular review, any stock with market capitalisation that ranks below the 60<sup>th</sup> position in the HSHKCI will be removed from the HSHKMI, while an stock with ranking above the 40<sup>th</sup> position will be included (Hang Seng Index Co Ltd, 2005).

stocks with new candidates as the occasion arises. Successful SmallCap firms can be promoted to MidCap firms. Likewise, prosperous MidCap firms can swap places with LargeCap firms, though not so frequently as SmallCap firms would. For the purpose of this study, the classification of a listed firm in the HSHKCI as at 5 September 2005 is ‘frozen’ retrospectively for the entire 3-year period of study. For example, a firm listed in the MidCap category at 5 September 2005 is treated as a MidCap firm throughout the entire period of study from 2003 to 2005, although it might have been promoted from the SmallCap category or demoted from the LargeCap category shortly before that date.<sup>6</sup>

#### 8.4 Period of study and annual report release dates

The sample period of this study covers the years 2003-2005. During this 3-year period, the CG disclosure data, market performance variables, accounting variables, and firm-related variables of each sample firm are collected. The rationale for selecting the period of study has been discussed in Section 5.4.2 of Chapter 5 and Section 7.3.1 of Chapter 7.

The total number of observations (firm-years) for the three categories of firms in the sample space is 258, and the breakdown is shown in Table 8.2. It can be seen from Column 6 of Table 8.2 that the sample size for SmallCap firms constitutes 54% of the whole sample; while for LargeCap firms, it represents only 14% (actual number of firm-years = 36). The proportion of SmallCap firms would very likely have a dominant effect on the entire sample space, while the LargeCap firms would seem to be under-represented.

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<sup>6</sup> As the historical changes in the composition of the HSHKCI stocks are not available to the public before September 2005 when data collection began (archived information of HSICO not accessible), this may pose a limitation on this study.

**Table 8.2: Sample observations (firm-years)**

	2003	2004	2005	Total	%
LargeCap	12	12	12	36	14
MidCap	26	27	29	82	32
SmallCap	44	48	48 *	140	54
Total	82	87	89	258	100

\* Notes:

1. In the SmallCap category, there were originally 50 non-financial firms as at 2005. China Resources Peoples Telephone was not yet listed in 2003. It cancelled its trading on 28/03/2006 thus no annual report for fiscal year 2005 was released. Pacific Century Premium Development changed its fiscal year in 2004 due to re-organisation and a major change of business nature. It produced an annual report in 2005 that covered a fiscal shorter than the normal 12 months, making the data non-comparable with other companies. For these reasons, both companies are deleted from the SmallCap sample of this study.
2. Four SmallCap firms, namely, Lifestyle International Holdings, Luen Thai Holdings, Pacific Basin Holdings, and Solomon Systech International, became listed companies only in 2005 and hence their back data for 2003 are not available. Their back data for 2004, however, are featured in their 2005 annual reports for comparative purposes. Hence, the number of valid observations in 2004 remains on par with 2005, and the total number of firm-years for the SmallCap category from 2003 to 2005 is maintained at 140.)

The CG disclosure data of the sample firms are collected from their annual reports. A total of 258 annual reports are examined. Other accounting data and market performance of the firms are obtained from Datastream (description on the definition of the variables has been presented in Chapter 7).

Sample firms in this study have various fiscal year-ends. Most of them have their fiscal year ended at December 31, some at March 31, and a few on other dates. For this study, the accounting data of these companies such as the book value of total assets, total equity, total debt, and leverage, etc. are extracted from Datastream as at the end of the fiscal year. The market value of equity and the share price are obtained from Datastream as at the date of release of the firm's annual report to HKEx (the annual report release date, or the ARR date). The ARR date is approximately three months after the fiscal year-end and is obtained from the website of HKEx ([www.hkex.com.hk](http://www.hkex.com.hk)).

During the period of study 2003-2005, the CG information of a listed firm publicly available to the investors was mainly reported in its annual reports.<sup>7</sup> Therefore, the

<sup>7</sup> It was not common for Hong Kong listed firms to set up their own company websites in 2005. At that time, only some of the LargeCap firms, few of the MidCap firms, and even fewer of the

source of information about the CG of the firms under study is the annual reports of the firms. It is likely that outside investors can only have a full knowledge of the firm's operation when the annual report becomes publicly available. The date that the annual report is first released to the public (i.e., the ARR date) is the earliest time that the outsiders can obtain the most recent information about the CG of a listed firm. For this study, the ARR date is used as the reference date for arriving at the market value of a listed firm as at that date. The CG information contained in the annual report of a listed firm is taken to be valid for the fiscal year prior to the ARR date unless it is specified otherwise. The ARR dates in respect of the sample firms for 2003 to 2005 are shown in **Appendix 1**. As the period of study is from fiscal year 2003 to 2005, the ARR dates span across three calendar years from 2004 to 2006. Based on these ARR dates, the market data on the sample firms are collected from Datastream.

## 8.5 Cross listing of sample firms

Previous studies as discussed in Section 6.3.2 of Chapter 6 have suggested that cross listing (or dual listing) can serve as a CG mechanism (Cooke, 1992; Lang, Raedy, and Yetman, 2003; Lang, Lins, and Miller, 2003). The information about a firm's cross listing status is not a mandatory disclosure requirement in the Corporate Governance Report. Yet, it is always disclosed in the annual reports of the firm (mainly under the "Corporate Information" section). In this study, some of the sample firms are dual-listed on other stock exchanges. Most of the dual-listed firms have an American Depositary Receipt status. **Appendix 1** presents the dual-listing status of the LargeCap, MidCap, and SmallCap sample firms respectively in this study as at September 2005.

Among the 3 market capitalisation groups of firms, it can be seen from **Appendix 1** that LargeCap firms have the highest percentage of cross listing. Out of the 12 LargeCap firms in the sample, 67% (i.e., 8 firms) had either an American Depositary

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SmallCap firms had the IT resources to build, maintain, and update their company websites. Even if a firm had constructed its own website by 2005, the construction of the website was rather rudimentary; and was more oriented to promoting sales of its products or services than to providing CG information to the general public. The information related to a firm's internal operation, including the information about its CG practices, that had been uploaded onto its official website was almost identical to the information that was disclosed in its annual reports – the entire annual reports were scanned and archived, with no supplementary information provided.

Receipt (ADR) listing status in the U.S., or the status of dual listing on other stock exchanges besides HKEx. Two of these eight LargeCap firms, Henderson Land Development and Hutchison Whampoa, had been qualified to trade their stocks on three exchanges in 2005. In the MidCap firms category, 28% (i.e., 8 firms) of 29 sample firms had an ADR status, or were dually listed on some other stock exchanges besides HKEx at that time (**Appendix 1**). In contrast, only 19% (or 9 firms) of the 48 SmallCap sample firms had cross-listing status (**Appendix 1**). The percentage of dual-listing firms increases with the firm's market capitalisation, which is consistent with the view that larger firms need more foreign capital; thus they are more willing to seek overseas listing (Reese and Weisbach, 2002). It also supports the view that dual-listed firms tend to disclose more information (Cooke, 1992) than non-dual listed firms. As a result, they are likely to operate in an information environment different from that of the non-dual listed firms.

It should also be noted that the status of cross listing of the sample firms was not static. The cross listing status of the sample firms was recorded as at 2005 (and retrospectively verified for 2003 and 2004 from the firms' annual reports). It would be expected that more firms from the same sample would become dually listed in the years after 2005.

The fact that a firm's stock is qualified to trade on another stock exchange outside Hong Kong indicates that the management of the firm is willing to subject itself to the scrutiny of an additional set of accounting standards and reporting regulations. As discussed in Section 4.2.4 of Chapter 4, the cross listing status can be a signal to the outside investors, which is provided voluntarily by the management, about the state of the corporate governance of the firm. As the present study aims to examine the relationship between voluntary disclosure of CG practices and a firm's valuation, the cross listing status of a firm is a relevant factor, and is treated as a dummy variable in the empirical models (i.e., takes on a value '1' if cross listed, '0' otherwise), which will be specified in Section 8.7 of this Chapter. The following section, Section 8.6, will discuss the data collection on CG practices from the annual reports of the sample firms.

## 8.6 Corporate governance data collection

In November 2004, the HKEx announced that all listed firms on the Hong Kong Stock Exchange would be required to comply with *the Code of Best Practice* for accounting periods commencing on, or after, 1 January 2005. All issuers of securities on the stock exchange were asked to issue a separate *Corporate Governance Report* in accordance with the requirements as stipulated in *Appendix 14: Code on Corporate Governance Practices* and *Appendix 23: Corporate governance Report of the Listing Rules*. Appendix 14 sets out the principles of good corporate governance and two levels of recommendations, namely, the code provisions and the recommended best practices. Appendix 23 sets out a list of recommended disclosure for the issuers' reference. They are not mandatory but intended to be areas on which the issuers may comment in their *Corporate Governance Report*. In sum, Appendix 14 states the principles of good corporate governance for the firms to apply, whereas Appendix 23 provides the format of a report for the firms to follow.

As explained in Chapter 5, HKEx had been engaging in dialogues with its listed member firms on the improvement of their corporate governance since early 2000s. Consultation papers had been drafted and issued to its members to solicit their opinions on the significance of good corporate governance practices to investors. Reports were written following the consultation works to consolidate the members' comments regarding the implementation of the desirable CG practices. The listed member firms had been strongly encouraged to adopt *the Code of Best Practices* since its first publication in 2002. The final HKEx report on the mandatory implementation of the *Code of Best Practices* in November 2004 was the result of a series of consultation works between the HKEx, the listed members, and the professional accounting organizations. In effect, Appendix 14 and Appendix 23 represent the final outcome of the negotiations over many years on the required disclosure of a firm's CG practices that are mutually acceptable to the regulators and the listed firms. As the format of the CG Report is specified in Appendix 23, it can be converted into a checklist to measure a listed firm's disclosure of its CG practices. It can also be used retrospectively to measure the firm's similar disclosure of its CG practices for the previous years, which was voluntary before and up to 2005.<sup>8</sup>

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<sup>8</sup> The rationale for treating the disclosure of a firm's CG practices for 2005 as voluntary has been discussed in Section 7.3.1 in Chapter 7.



Data on the CG of the listed firms under study are collected from the annual reports of the firms for the fiscal years from 2003 to 2005. To collect the CG information, the following nine sections of the companies' annual reports are examined:

- (i) Director Report;
- (ii) Corporate Governance Report (if any);
- (iii) Audit Committee Report (if any);
- (iv) Remuneration or Compensation Committee report (if any);
- (v) Nomination Committee Report (if any);
- (vi) Profile (or Biography) of Directors and Senior Management;
- (vii) Corporate Information;
- (viii) Investors Relations (if any);
- (ix) Important Dates (or Company Calendar).

To facilitate the collection of CG information from past annual reports of the sample firms, a checklist for recording the CG disclosure is needed. The following subsection, Section 8.6.1, explains the construction of the CG disclosure checklist.

### **8.6.1 Construction of the CG Disclosure Checklist**

A CG disclosure checklist is developed with reference to the *Code Provisions* and *Recommended Best Practices* as stipulated in Appendix 23 of the *Listing Rules*. The checklist consists of 66 single-barrel questions on CG disclosure, two thirds of which are on the items from the *Code Provisions* section and the remaining one third from the *Recommended Best Practices* section. Similar to Appendix 23, these 66 questions are grouped under nine categories of mandatory disclosure and five categories of recommended disclosures as follows:

#### **A) Mandatory disclosure**

1. Corporate governance practices;
2. Directors' securities transactions;
3. Board of directors;
4. Chairman and Chief Executive Officer;
5. Non-executive Directors;
6. Remuneration of directors;
7. Nomination of directors;
8. Auditors' remuneration; and
9. Audit Committee.

#### **B) Recommended disclosure**

1. Share interests of senior management;
2. Shareholders' rights;
3. Investor relations;
4. Internal controls; and
5. Management functions.

For each single-barrel question on the checklist, there are three possible answers:

- 'Yes' if there is disclosure of relevant contents in the annual reports;
- 'No' if no disclosure of relevant contents is found;
- 'Not Applicable' if the question does not apply to the sample firm.

For example, a provision for setting up a Nomination Committee is broken down into several questions that can be answered with any one of the three suggested answers. The first question asks whether a Nomination Committee has been established, to which an answer can be either 'Yes' or 'No'. The second question enquires whether the composition of the Nomination Committee is disclosed. If a firm has not set up a Nomination Committee in the first place, then the most proper answer to the second question should be 'Not Applicable'. A 'No' answer to the second question in that case would be construed as indicating the firm's non-disclosure of the composition when it has already established the Nomination Committee. A copy of the CG checklist is presented in **Appendix 2** of this study.

When applied retrospectively for the year 2003 and 2004, the same checklist can be used to ascertain if firms had been prepared to disclose their CG practices on a *voluntary* basis. As explained in Chapter 5, HKEx had informed, and the Hong Kong Society of Accountants (HKSA) had advised, the listed firms to disclose their CG practices several years in advance before the *Code on Corporate Governance Practices* became mandatory in 2005. However, listed firms were at liberty to choose as to when to disclose their compliance with the *Code*, how much to disclose, or whether to disclose their CG practices at all at that time. Using the CG disclosure checklist based on the mandatory requirements in 2005 to assess retrospectively the extent of voluntary disclosure in 2003 and 2004, will provide a common denominator for comparing the voluntary disclosure of all listed firms.

### **8.6.2 Construction of the CG disclosure index**

Based on the answers to the questions in the checklist, a CG disclosure index, CGDscore, is compiled. One point is given for a 'Yes' answer and zero for a 'No' answer. The total score of CG disclosure, the CGDscore, is the sum of all points for the 'Yes' answers divided by the net number of relevant questions (i.e., 66 minus the number of 'Not Applicable' answers), multiplied by 100. Hence, the possible range for CGDscore is 0~100. This dichotomous scoring method has been used in prior studies (e.g., Cooke, 1989a; Wallace, Naser, and Mora 1994; Chau and Gray, 2002; Gul and Leung, 2004) and the approach in coding 'Yes' and 'No' net of the 'Not Applicable' answers has been commonly practiced.

All answers to the questions carry equal weighting in the compilation of the index. There are merits in this approach over an index compiled with unequal weighted scoring system for different aspects of CG practices. First, there is no economic theory in support of any particular aspect of CG practice being more important or valuable than others. Any importance assigned to an aspect of disclosure may bring about a certain degree of subjectivity, depending upon the users of the index. It may also reflect the extent to which the importance of such information meant to that specific group of users (Firth, 1979), which may vary with other groups. Using an equal-weight (or un-weighted) scoring system permits an analysis to be independent of the perceptions of a particular user group (Chow and Wong-Boren, 1987).

Second, using an equal-weight measuring approach implies that each item of disclosure is considered to be equally important. It allows different facets of the index to be additive so that a direct link is established between the index and the number of aspects of CG practices that are disclosed. In contrast, when different users assign different weights to various provisions of the CG Disclosure Code, the subjective weights assigned to the provisions may average each other out in the final score so that no differentiation can be made between the importance and the quantity of provisions disclosed. Clearly, it is possible for one group of users (e.g., creditors) to attach a level of importance to an item of disclosure that is different from another group of users (e.g., analysts). A specifically weighted measurement therefore only represents the perceived importance of the disclosure items by some specific group

of users. It does not necessarily represent a *stable* perception across *all* users over time (Dhaliwal, 1980, p. 387).

Third, the un-weighted scoring approach has been employed and supported in many prior studies (e.g., Ahmed and Nicholls, 1994; Cooke, 1991; Meek, Roberts, and Gray, 1995; Wallace and Naser, 1995; Chau and Gray, 2002) and the results of prior studies have suggested that weighted and un-weighted disclosure indices are interchangeable because their effects are equivalent (Chow and Wong-Boren, 1987, p. 536-538). Moreover, the focus of this study is not to cater to the needs of one particular user group but to the general users of the disclosure index. An approach that tries to encapsulate the subjective weights assigned by a multitude of user groups would be unwieldy and probably futile (Cooke, 1989a). For these reasons, this study will adopt an unweighted approach in the construction of the CGDscore.

## 8.7 Research design and methodology

This section discusses two aspects of research in this study. Section 8.7.1 describes the research design and explains the formation of three different sampling groups. Section 8.7.2 accounts for the choice of methodology.

### 8.7.1 Research design

Table 8.2 in Section 8.4 of this chapter shows the sampling frame of 258 observations, which consist of 36 firm-years for LargeCap, 82 for MidCap, and 140 for SmallCap firms. If the entire sampling frame is treated as one homogenous group (similar to the treatment by previous researchers like Chen and Jaggi, 2000; Cheung, Connelly, Limpaphayom, and Zhou, 2007), there is a potential risk that the test results thus obtained would be unduly influenced by SmallCap firms, which represent 54% of the total observations. On the other hand, if the sampling frame is split up into 3 separate groups of LargeCap (L), MidCap (M), and SmallCap (S) firms individually, the small size in the L sample (i.e., 36 firm-years) may not support a reliable statistical analysis due to its low degree of freedom (i.e., 12 firms' data over 3 years, but there are 15 explanatory variables at maximum in some models).

Therefore, the research design of this study is re-shaped as follows. The entire sampling frame is composed of observations from LargeCap, MidCap, and SmallCap firms. They can be grouped into three sub-samples:

- (i) LargeCap, MidCap, and SmallCap firms (L+M+S) sample;
- (ii) LargeCap and MidCap firms (L+M) sample; and
- (iii) SmallCap firms (S) sample.

Under such grouping, the (L+M+S) sample provides a sample size with 258 observations, the (L+M) sample with 118 observations, and the (S) sample with 140 observations. Provided that LargeCap firms are not entirely irreconcilable with MidCap firms on every attribute, this grouping shall yield a bigger sample size for testing the models with a higher statistical power.

In addition to the practical need for an increased sample size for the LargeCap firms, there are also justifications for grouping them with MidCap firms to form a combined L+M sample, while leaving the SmallCap firms as a stand-alone sample. Firstly, prior studies on Hong Kong firms rarely single out the small firms as focus of study. In contrast, the present study offers an alternative to compare and contrast the voluntary disclosure behaviour of small firms with that of larger firms. Secondly, LargeCap firms and MidCap firms have more analysts following (as suggested by their higher propensity for cross listing) than SmallCap firms (Cooke, 1989a; Lang, Raedy, and Yetman, 2003). It is suggested that the information asymmetry between the insiders (i.e., managers) and the outsiders (i.e., investors) tends to be bigger for the small firms (Cheung, Stouraitis, and Wong, 2005). Compared to small firms, the total information set on large and medium firms available to outside investors is likely to be larger (Berglof and Pajuste, 2005). Hence, combining LargeCap and MidCap firms to form an (L+M) sample is less likely to distort their overall characteristics in terms of information environments.

The descriptive statistics of LargeCap, MidCap, and SmallCap firms in terms of their financial performance, market performance, accounting ratios, and CG characteristics are presented in Chapter 9, where further justifications for grouping LargeCap firms with MidCap firms will be provided.

### **8.7.2 Methodology**

A multiple ordinary least square regression (OLS) is applied to test the hypotheses between voluntary CG disclosure (i.e., dependent variable) and other firm characteristics and control variables (i.e., independent variables). Lang and Lundholm (1993) point out that multiple regressions offer a methodology to examine the incremental explanatory power of the variables. However, when the theoretically correct form of the relationship between the dependent variable and the explanatory variables is not known, rank regressions may be useful in analysing the data. For example, if the relationship between the dependent variable (e.g., Tobin's  $q$ ) and the explanatory variables (e.g., the CG characteristics) is monotonic, implying that the dependent variable changes in just one direction – either up or down as the explanatory variables increase, a higher-ranked explanatory variable will correspond to a higher-ranked dependent variable, regardless of the precise relationship between the two variables when they are unranked (Lang and Lundholm, 1993, p. 262-264; Wallace, Naser, and Mora, 1994, p. 47). This study will primarily use the OLS methodology in testing the models, and use ranked data in the regression models if necessary. In the following sections, the hypotheses as stated in Chapter 6 will be specified into models, with reference to the studies by extant researchers as previously discussed in Chapters 2 - 4.

## **8.8 Model specification**

This section features the specification of the models. These models are constructed with the variables defined in Chapter 7 and are empirically tested in the next chapters. The models are developed with reference to the hypotheses stated in Chapter 6. Under usual circumstances, one specific model is constructed to test one hypothesis. In some cases, however, several sub-hypotheses can be simultaneously tested by a single model.

### **8.8.1 Hypothesis 1 (H1)**

As explained in Section 6.3.1 of Chapter 6, the following hypothesis (H1) hypothesizes a relationship between voluntary CG disclosure and firm valuation:

### Hypothesis 1

*H1*: Firms that voluntarily disclose more information with regard to their corporate governance practices have higher market valuation than firms that disclose less, *ceteris paribus*.

Following Morck, Shleifer, and Vishny (1988); McConnell and Servaes (1990); Kaplan and Zingales (1997); Gompers, Ishii, and Metrick (2003); Cremers and Nair (2005); and Durnev and Kim (2005), firm valuation is proxied by the approximation of Tobin's  $q$ , calculated as follows:

$$q = \frac{(\text{Total assets} + \text{market value of equity} - \text{book value of equity} - \text{deferred tax})}{\text{Total assets}}$$

where  $q$  is the approximation for Tobin's  $q$ .

Total assets, book value of equity, and deferred tax for sampled firms are measured as at the end of fiscal year  $t$ . Market value of equity for each firm is measured as at the Annual Report Release Date, which is about 3 months after the end of fiscal year  $t$  and is recorded in the HKEx website. The data for all variables needed for the computation of a firm's  $q$  are obtained from Datastream. The information of CG practices voluntarily disclosed by a firm is proxied by the CG disclosure score (CGDscore). Detailed discussion of the definitions of each variable and the computation of each construct has been presented in Chapter 7.

To empirically test Hypothesis 1, a firm's  $q$  is estimated as a function of CGDscore, and the model is specified as follows:

### Model 1.0

$$q_{i,t} = \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \varepsilon_{i,t} \quad (\text{Model 1.0})$$

where  $q_{i,t}$  is an approximation of Tobin's  $q$  as previously defined;  $\text{CGDscore}_{i,t}$  is the corporate governance disclosure score for firm  $i$  in period  $t$ ;  $\beta_0$ ,  $\beta_1$  are parameter estimates;  $\varepsilon_{i,t}$  is the error term, and subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, \dots, n$ , and subscript  $t$  denotes fiscal year where  $t = 1, 2, 3$ .

Model 1.0 is extended to incorporate other aspects of a firm's CG disclosure, known collectively as the *CGprac* variables in this study, which include the following five variables:

- board size (BoDsize);

- the number of independent non-executive directors (INEDs) appointed to the board (NumINED);
- the proportion of the INEDs of the board members (INED%);
- the splitting of the dual roles of the Chairman from the Chief Executive Officer (SplitRole); and
- Dual listing (DualList) status.

A control variable (Dir%Own), which denotes Directors' Ownership expressed as the percentage of common shares owned by all directors, is also added into the extended model. The extended model, Model 1.1, is therefore specified as follows:

Model 1.1

$$q_{i,t} = \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \sum_{j=1}^k \beta_j \text{CGprac}_{i,t} + \beta_2 \text{Dir\%Own}_{i,t} + \varepsilon_{i,t} \quad (\text{Model 1.1})$$

where  $q_{i,t}$ ,  $\text{CGDscore}_{i,t}$  are as defined in Model 1.0;  $\beta_0$ ,  $\beta_1$ , and  $\beta_2$  are parameter estimates,  $\beta_j$  is a vector for the parameters of the  $\text{CGprac}_{i,t}$ ; where  $\text{CGprac}_{i,t}$  is a family of variables that comprises five ( $k=5$ ) variables on CG practices:

- $\text{BoDSize}_{i,t}$  = total number of all director on the board of directors;
- $\text{NumINED}_{i,t}$  = the number of INEDs sitting on the board of directors;
- $\text{INED\%}_{i,t}$  = the percentage of INEDs of the total number of directors;
- $\text{SplitRole}_{i,t}$  = a dummy variable '1' for split role of CEO and Chairman, '0' otherwise;
- $\text{DualList}_{i,t}$  = a dummy variable '1' for cross listing on any other exchange, 0 otherwise; and

$\text{Dir\%Own}_{i,t}$  is the percentage of common shares owned by the directors;  $\varepsilon_{i,t}$  is the error term; subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3, \dots, n$ ; subscript  $t$  denotes fiscal year where  $t = 1, 2, 3$ ; and subscript  $k = 1, 2, \dots, 5$ .

In addition to a firm's CG practices, prior accounting research suggests that a number of financial performance factors may also influence the firm's valuation (e.g., Mitton, 2002; Eng and Mak, 2003; Hutchison and Gul, 2004). These factors are more closely related to the financial conditions of the firm than to the industry or market in which the firm operates. Model 1.1 is therefore extended further to take these financial performance factors into consideration as control variables. In this study,



these financial performance factors are collectively represented by Company Characteristics (ComChar) variables, which include the following:

- the firm's profitability as proxied by return on equity (ROE);
- the firm's sustainable income as proxied by the natural log of sales (LnSales);
- the firm's growth prospect as proxied by the year-on-year sales growth (SalGrow);
- the firm's resources as proxied by the natural log of equity (LnEqty); and
- the firm's leverage as proxied by the debt ratio (Debt/Total Assets).

### Model 1.2

$$q_{i,t} = \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \sum_{j=1}^k \beta_j \text{CGprac}_{i,t} + \sum_{m=1}^p \beta_m \text{ComChar}_{i,t} + \beta_2 \text{Dir}\% \text{Own}_{i,t} + \varepsilon_{i,t} \quad (\text{Model 1.2})$$

where  $q_{i,t}$ ,  $\text{CGDscore}_{i,t}$ ,  $\text{CGprac}_{i,t}$ , and  $\text{Dir}\% \text{Own}_{i,t}$  are as previously defined;  $\beta_0$ ,  $\beta_1$ , and  $\beta_2$  are parameter estimates;  $\beta_j$ ,  $\beta_m$  are vectors,  $\varepsilon_{i,t}$  is the error term; subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3, \dots, n$ ; subscript  $t$  denotes fiscal year where  $t = 1, 2, 3$ ; subscript  $k = 1, 2, \dots, 5$ ; subscript  $p = 1, 2, \dots, 5$ ; and  $\text{ComChar}_{i,t}$  is a family of company characteristics variables which represent a firm's financial performance and consist of the following five control variables:

- $\text{ROE}_{i,t}$  = return on equity;
- $\text{LnSales}_{i,t}$  = natural log of a firm's sales;
- $\text{SalGrow}_{i,t}$  = sales growth over previous year;
- $\text{LnEqty}_{i,t}$  = natural log of a firm's equity<sup>9</sup>; and
- $\text{Debt/TA}_{i,t}$  = debt ratio (i.e., Debt/TA) expressed in percentage;

The above-mentioned models, namely, Models 1.0, 1.1 and 1.2, are applied to the three samples mentioned in Section 8.7.1, namely, the pooled LargeCap, MidCap, and SmallCap (L+M+S) sample, the combined LargeCap and MidCap (L+M) sample, and the SmallCap (S) sample.

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<sup>9</sup> The Total Assets (TA) of a firm is not used here as a proxy for a firm's resources because  $q$ , the dependent variable on the left hand side of a regression model, consists of a component - the book value of total assets. Putting TA on the right hand side of the model to test for  $q$  will likely cause an upward biased coefficient of determination  $r^2$  in the regression.

These models are specified with OLS methodology, which can test the strength of the linear relationship between the dependent variable  $q$  (the market valuation of a firm) and the explanatory variables (such as CGDscore, amongst others).

Previous research indicates that a firm's valuation proxied by  $q$  is associated with insiders' shareholding, and the relationship may be non-linear (Morck, Shleifer, and Vishny, 1988; McConnell and Servaes, 1990). In addition, Claessens and Fan (2002) posit that shareholders will discount the stocks according to the perceived CG issues. It seems plausible that a firm's share prices (and thus its market valuation) can be *jointly* affected by both the insiders' ownership and the CG practices of a firm – the former being proxied by the directors' ownership (Dir%Own) and the latter by the voluntary CG disclosure (CGDscore) of the sample firms in this study. Yet, few studies have tested the potential *joint* effect of insiders' shareholding *and* voluntary CG disclosure on a firm's valuation. This study aims at exploring such relationship using a specific research design, as explained in the following sub-section.

#### **8.8.2 Level of Directors' Ownership, CG rank, and $q$**

As documented in the literature review in Section 3.2.8 of Chapter 3 and the hypotheses development sections in Chapter 6, firms that are tightly held or owned by insiders often have their owners as managers, and resulting in entrenchment problems rather than classical agency problems. When the CG of a tightly insider-owned firm is poor, outsiders are expected not to pay a high price for its stock (Claessens and Fan, 2002). A firm's CG practice, therefore, is likely to have a discernable impact on a firm's market valuation. However, outsiders may not be able to assess the state of a firm's CG unless the insiders (i.e., the management) voluntarily disclose it. Suppose there are two firms, Firm A and Firm B, which have comparable level of insiders' ownership. If Firm A is voluntarily disclosing more information on its CG practices than Firm B, it is likely that outside investors will regard Firm A (i.e., with higher CG disclosure) as having implemented *more* CG mechanisms than Firm B. More mechanisms installed within a firm imply a *higher* commitment to investor protection by the management. Subsequently, outside investors may infer that Firm A provides more investor protection, hence a *better* CG, than Firm B, when the levels of insiders' ownership of both firms are comparable. The share price of Firm A will be rated higher. Hence, *ceteris paribus*, it can be hypothesized:

### 8.8.3 Hypothesis H1a

H1a: Low CG rank firms have lower  $q$ , controlling for the level of insiders' ownership.

Before a model is specified to test H1.a, it is necessary to define clearly the meaning of 'High' and 'Low' in the CG ranking of a firm. In this study, a firm's CGDscore is ranked as 'High' if it is above the median CGDscore of the group of firms to which the firm is placed, and 'Low' if it is below. The median CGDscore is a better threshold than the mean CGDscore in this case because, at the median, 50% of the sample firms have a higher CGDscore and 50% of the sample firms have a lower CGDscore.

The insiders' ownership of a firm may have impact on the firm's voluntary CG disclosure. For different levels of insider ownership, there may be different attitudes towards voluntary CG disclosure. An insider who owns a predominant shareholding of a firm may not feel obliged to disclose voluntarily the CG practices more than is necessary to the outside investors, because the minority shareholders do not have sufficient voting power to demand more disclosure. On the other hand, an insider with low level of ownership may feel compelled to disclose more (as discussed in the literature review in Chapter 2 and Section 6.3.2 in Chapter 6). While the absolute difference between the CGDscores of two firms may not result in a corresponding difference of equivalent magnitude in the valuation of the firms, the difference in the *ranking* of the CGDscores may indicate a categorical difference in the managers' attitudes towards their CG practices. Generally, it is expected that outside investors would prefer a relatively high CG-ranking firm to a relatively low CG-ranking firm. Therefore, in order to specify a model for testing H1a, both the CG ranking and the insiders' ownership level of the firm should be considered.

In considering the method of measuring the insider ownership levels of a firm, reference is made to the practices adopted in prior studies. In a study to account for the possibility that variations in ownership levels affect corporate value, Wiwattanakantang (2001) categorizes the sample of Thai firms into four groups according to the shares held by the largest shareholder group. The levels of ownership are 0-25%, 25-50%, 50-75%, and 75-100%. Chau and Gray (2002), in

their empirical study of Hong Kong firms, use the same method to divide their ownership variable into quartiles: 1-25%, 25-50%, 50-75%, and 75-100%, to test the relationship between higher ownership and the extent of voluntary disclosure. Leung and Horwitz (2004) use 25% director ownership as the threshold to classify Hong Kong firms into their high (above 25%) or low (below 25%) ownership samples. It seems that the categorization of insider ownership into quartiles is a commonly adopted practice in measuring the level of ownership in a firm.

The sample of Hong Kong listed firms in this study is thus categorized into groups according to the level of directors' (or insider) ownership. It is desirable to follow similar practice in adopting the quartile method used in prior studies to facilitate comparison of test results, if necessary. Hence, directors' ownership of the sample firms in this study will be categorised into ownership levels of 0-25%, 25-50%, and 50-75% and 75%-100%. However, it is noted that in the *Listing Rules* of HKEx, the public float of shares of a listed firm, i.e., issued share capital to be held by "unconnected persons" (those with no family relationship with the members of a firm's board of directors) and the general public, is set at 25% or more of the issued share capital (HKEx, 2005). The maximum level of issued share capital of the listed firm that an insider can own is thus capped at 75%. Although the quartile method is used in categorizing the level of ownership in this study, in effect the feasible range of directors' ownership will spread to three quartiles only, i.e., 0-25%, 25-50%, and 50-75%. As explained in Section 6.3.5 in Chapter 6, an insider enjoys predominance once he owns more than 50% equity of the firm. There is no difference in practice between a 50% ownership and a 75% ownership, as both levels of ownership yields predominance in ownership. Therefore, in this study, the level of insider ownership of a firm is classified as follows:

- (i) 0 - 25% (Low ownership);
- (ii) 25-50% (Medium ownership), and
- (iii) 50% or more (Predominant ownership).

They are referred to as Low, Medium, and Predominant director's ownership (Dir%Own) groups respectively. The Predominant group signifies those directors-cum-owners who have predominant ownership of more than 50%.

As discussed earlier, firms can be ranked into two levels in terms of CG ranking (CG\_rank) with reference to the median of CGDscore pertaining to each sample:

- (i) High level of CG disclosure (H); and
- (ii) Low level of CG disclosure (L).

Those firms with CGDscore higher than the median will be ranked as ‘H’, and those with CGDscore lower than the median will be ranked as ‘L’. It should be noted that the classification of ‘H’ or ‘L’ is a relative measure (i.e., ‘H’ and ‘L’ are relative to each other); whereas in the ownership classification, a Predominant director ownership group has always had a majority of shareholding.

The measurement of a firm’s CG ranking (CG\_rank) and its level of director’s ownership (Dir%Own) is now presented in a 2x3 matrix, as shown in Table 8.3 below. There are six different combinations of CG\_rank and Dir%Own Groups, namely, HL, HM, HP, LL, LM, and LP, which represent the respective level of CG ranking and director’s ownership of a firm in a sample.

**Table 8.3 A 2x3 matrix on CG ranking and Director’s Ownership of a firm**

	1	2	3	4
1		Dir%Own (Director’s Ownership)		
2	CG_rank (vs. median)	Low (0-25%)	Medium (25-50%)	Predominant (50%+)
3	High	HL	HM	HP
4	Low	LL	LM	LP

Using the high CG\_rank and low DirOwnGrp (HL) as the base group (highlighted in row 3, column 2 of Table 8.3), five dummy variables are set up to denote the other five different combinations of CG-ranking and director’s ownership, stated in Table 8.4 as follows:

**Table 8.4 Dummy variables of the joint CG\_rank and Dir%Own Group**

DV_HM	High CG_rank and Medium Dir%Own Group
DV_HP	High CG_rank and Predominant Dir%Own Group
DV_LL	Low CG_rank and Low Dir%Own Group
DV_LM	Low CG_rank and Medium Dir%Own Group
DV_LP	Low CG_rank and Predominant Dir%Own Group

These 5 dummy variables, together with other control variables, will be used in the model for testing hypothesis H1a. Model 1.3 is thus specified as follows:

Model 1.3

$$q_{i,t} = \beta_0 + \beta_1 \text{BoDsize}_{i,t} + \beta_2 \text{NumINED}_{i,t} + \beta_3 \text{INED\%}_{i,t} + \beta_4 \text{SplitRole}_{i,t} \\ + \beta_5 \text{DualList}_{i,t} + \beta_6 \text{ROE}_{i,t} + \beta_7 \text{LnSales}_{i,t} + \beta_8 \text{SalGrow\%}_{i,t} + \beta_9 \text{LnEqty}_{i,t} \\ + \beta_{10} \text{Debt/TA}_{i,t} + \beta_{11} \text{DV\_HM}_{i,t} + \beta_{12} \text{DV\_HP}_{i,t} \\ + \beta_{13} \text{DV\_LL}_{i,t} + \beta_{14} \text{DV\_LP}_{i,t} + \beta_{15} \text{DV\_LM}_{i,t} \\ + \varepsilon_{i,t} \quad (\text{Model 1.3})$$

where all the variables are as previously defined;  $\beta_0, \beta_1, \beta_2, \dots, \beta_{15}$  are parameter estimates;  $\varepsilon_{i,t}$  is the error term; subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3, \dots, n$ ; and subscript  $t$  denotes fiscal year where  $t = 1, 2, 3$ .

The sample space for Model 1.3 is presented in Table 8.5 below, where Panel A denotes the 3-year pooled sample (L+M+S), Panel B denotes the 3-year LargeCap and MidCap combined sample (L+M), and Panel C denotes the 3-year SmallCap sample (S). The median of CGDscore for each sample, based on which a firm's CG disclosure is compared and categorized as being High or Low in CG\_rank, is stated in each panel.

**Table 8.5 Sampling frames for Model 1.3**

	Dir% Own Group			
CG_rank	Low (0-25%)	Medium (25-50%)	Predominant (50%+)	Total
Panel A: Pooled sample (L+M+S) Median of CGDscore = 34.43)				
High	31	40	58	129
Low	18	44	67	129
<b>Total</b>	<b>49</b>	<b>84</b>	<b>125</b>	<b>258</b>
Panel B: Combined sample(L+M) Median of CGDscore = 42.15)				
High	7	24	28	59
Low	0	23	36	59
<b>Total</b>	<b>7</b>	<b>47</b>	<b>64</b>	<b>118</b>
Panel C: SmallCap sample (S) Median of CGDscore = 31.68)				
High	24	14	32	70
Low	18	23	29	70
<b>Total</b>	<b>42</b>	<b>37</b>	<b>61</b>	<b>140</b>

It should be noted that in Panel B (i.e., the L+M sample), no entry is recorded for the combination LL (i.e., Low CG\_rank and Low Dir%Own Group) as there was no firm in that Panel that had a Low CG\_rank and an insider ownership of less than 25%.

## 8.8.4 Hypothesis 2 (H2)

Hypothesis 2 (*H2*) postulates that the level of voluntary CG disclosure by a firm is influenced by factors including: insiders' ownership; the number of independent executive directors (INED) on the board; a firm's resource availability; the status of cross listing of the firm; and the split roles of Chairman and CEO, as suggested by extant researchers and presented in Chapter 2 and Chapter 6 of this study. Previous research studies by Eng and Mak (2003) and Berglof and Pajuste (2005) find that a more concentrated ownership tends to lower a firm's disclosure level. Pearce and Zahra (1992) and Mayer, Shivdasani, and Smith (1997) hypothesize that the number of INEDs should have a positive impact on the level of a firm's voluntary disclosure. Berglof and Pajuste (2005) find that the voluntary disclosure of information is positively associated with resource availability of a firm in Central and Eastern Europe. In particular, larger firms and firms with less leverage tend to disclose more information (*ibid*, 2005, p. 179). They suggest that more resources available to a firm (as indicated by a firm's sales) would attract more attention from various investors. The firm would then face a higher demand for information, and hence should be associated with a higher level of voluntary disclosure. Cooke (1989a) and Lang, Raedy, and Yetman (2003) expect the cross-listed firms to be more transparent because, by raising the level of voluntary disclosure, the firms imply a lower risk for expropriation to the outside investors. These researchers' theories and conjectures are incorporated into five hypotheses under Hypothesis 2 as stated in Chapter 6 of this study but are re-stated here with the specified variables as follows:

### Hypothesis H2a

A firm's voluntary CG disclosure is negatively related to the insiders' ownership (proxied by the directors' equity shareholding as a percentage of total outstanding shares (Dir%Own)).

### Hypotheses H2b(1) and H2b(2)

A firm's voluntary CG disclosure is positively related to the number of INEDs (NumINED) and the percentage of INEDs sitting on the board (INED%), controlling for the size of the board (BoDsize).

### Hypothesis H2c

A firm's voluntary CG disclosure is positively related to the firm's resource availability as proxied by sales (LnSales), controlling for profitability (ROE), size (LnTA), and leverage (Debt/TA).

### Hypothesis H2d

Firms that are cross-listed (DualList) voluntarily disclose more information about their corporate governance.

### Hypothesis H2e

Firms that split the roles of CEO and Chairman (SplitRole) have a higher voluntary CG disclosure.

A multiple regression model for these five sub-hypotheses can be specified as follows:

#### Model 2.0

$$\begin{aligned} \text{CGDscore}_{i,t} = & \beta_0 + \beta_1 \text{BoDsize}_{i,t} + \beta_2 \text{NumINED}_{i,t} + \beta_3 \text{INED\%}_{i,t} + \beta_4 \text{SplitRole}_{i,t} \\ & + \beta_5 \text{DualList}_{i,t} + \beta_6 \text{Dir\%Own}_{i,t} + \beta_7 \text{ROE}_{i,t} + \beta_8 \text{LnSales}_{i,t} \\ & + \beta_9 \text{SalGrow}_{i,t} + \beta_{10} \text{LnTA}_{i,t} + \beta_{11} \text{Debt/TA}_{i,t} \\ & + \varepsilon_{i,t} \end{aligned} \quad (\text{Model 2.0})$$

where  $\text{CGDscore}_{i,t}$ ,  $\text{ROE}_{i,t}$ ,  $\text{LnSales}_{i,t}$ ,  $\text{SalGrow}_{i,t}$ , and  $\text{Debt/TA}_{i,t}$  are as defined previously in Model 1.2;  $\beta_0, \beta_1 \dots \beta_{11}$  are parameter estimates;  $\varepsilon_{i,t}$  is the error term, and

- $\text{BoDsize}_{i,t}$  = the board size (total number of directors on the board);
- $\text{NumINED}_{i,t}$  = the number of INEDs sitting on the board of directors;
- $\text{INED\%}_{i,t}$  = the percentage of INEDs of the total number of directors;
- $\text{SplitRole}_{i,t}$  = a dummy variable 1 for split role of CEO and Chairman, 0 otherwise;
- $\text{DualList}_{i,t}$  = a dummy variable 1 for dual listing of the firm  $i$ , 0 otherwise;
- $\text{Dir\%Own}_{i,t}$  = the percentage of common shares owned by the directors;
- $\text{LnTA}_{i,t}$  = the natural log of total assets;

and subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3 \dots, n$ ; and subscript  $t$  denotes fiscal year where  $t = 1, 2, 3$ .

### **8.8.5 Hypothesis 3 (H3)**

As discussed in Section 6.3.3 in Chapter 6, Hypothesis 3 (H3) hypothesizes that large firms would have systematically different disclosure behaviour than small firms. Large firms tend to be more complex, and are more likely to face a demand from outside investors for more detailed reporting (e.g., segment reporting). In order to close the information gap between the outsiders and the insiders, large firms would be expected to disclose more information voluntarily than small firms, as they would have more resources (Bushman, Piotroski, and Smith, 2004). On the other hand, small firms are usually characterized with a high level of insider ownership, and greater information asymmetry between owners-managers and outside investors,



because they are followed by fewer analysts compared to large firms (Cheung, Stouraitis, and Wong, 2005, p. 522-525). From the information asymmetry point of view, small firms with entrenched managers are expected to be less likely to enhance voluntary disclosure to the outsiders. Therefore, it is hypothesized that a systematic difference exists between LargeCap and SmallCap firms in terms of their voluntary disclosure behaviour. To put this hypothesis into testing, the original *H3* is re-stated below and split up into 4 sub-hypotheses, i.e., *H3a* to *H3d*, as follows:

### Hypothesis 3

*H3*: There are systematic differences in the voluntary CG disclosure between LargeCap firms and SmallCap firms in both the level of disclosure and the value relevance of disclosure.

There are three aspects to test the differences in Hypothesis 3: (i) the level of disclosure; (ii) the market valuation as proxied by Tobin's *q*; and (iii) the value relevance of disclosure. In the following sub-sections, Hypotheses *H3a* and *H3b* test for the level of disclosure and Tobin's *q* respectively, while Hypotheses *H3c* to *H3e* test for the value relevance of disclosure. Different tests will be carried out on these three aspects.

#### (i) Level of disclosure

To facilitate quick reference, sub-hypothesis *H3a* postulated on the systematic differences on the level of voluntary disclosure amongst the three types of sample firms, as originally discussed in Section 6.3.3, is re-stated as follows:

### Hypothesis H3a

*H3a*: There are systematic differences in the voluntary CG disclosure of LargeCap firms and MidCap firms.

To test *H3a*, a one-way ANOVA (analysis of variance) test is run amongst the three groups of firms (i.e., LargeCap, MidCap, and SmallCap) on their CGD Scores.

Let :

$CG_L$  = the mean of LargeCap firms' CGDscore;

$CG_M$  = the mean of MidCap firms' CGDscore;

$CG_S$  = the mean of SmallCap firms' CGDscore

An ANOVA test is to be used to test the null hypothesis given by:

### Model 3.0

$H_0$ :  $CG_L = CG_M = CG_S$

$H_1$ : At least one of them is different

(Model 3.0)

An  $F$  test using  $F$  statistics is used to test whether the above-mentioned null hypothesis can be rejected, subject to the  $(k - 1)$  degrees of freedom in the numerator and  $(N_1 + N_2 + N_3 - k)$  degrees of freedom in the denominator, where:

$k$  = number of groups;

$N_1$  = sample size of group 1 (LargeCap firms);

$N_2$  = sample size of group 2 (MidCap firms); and

$N_3$  = sample size of group 3 (SmallCap firms).

The decision rule is: if the calculated  $F$  statistic is sufficiently larger than a critical value  $F_{crit}$  (e.g.,  $\alpha = 0.05$ ), then the means across all groups are not all equal.

If the null hypothesis is rejected, further tests (i.e., a post hoc test using the Tukey method) will be carried out to test the significance of differences between the means of paired groups. According to the *National Institute of Standards and Technology (NIST) Handbook*, the Tukey method (or the Tukey-Kramer method) is a single-step multiple comparison procedure and statistical test generally used in conjunction with an ANOVA to find out which means are significantly different from one another. It compares all possible pairs of means ( $\mu_i, \mu_j$ ) and is based on a *studentized range* distribution  $q$  (this distribution is similar to the distribution of  $t$  from the  $t$ -test). The test compares the means of every treatment to the means of every other treatment. It applies simultaneously to the set of all pairwise comparisons ( $\mu_i - \mu_j$ ) and identifies the cases where the difference between two means is greater than the standard error would be expected to allow. When all sample sizes are equal, the confidence coefficient for the set is exactly  $1 - \alpha$ . For unequal sample sizes, however, the confidence coefficient is greater than  $1 - \alpha$ . In a sense, the Tukey method is conservative when there are unequal sample sizes. The Tukey tests will be conducted on a year-on-year basis from 2003 to 2005 for LargeCap, MidCap, and SmallCap firms as they are of unequal sample sizes<sup>10</sup>.

(ii) Market valuation of firms as proxied by Tobin's  $q$

Similar ANOVA test can also be applied to test whether different groups of firms have systematically different market valuations (as proxied by Tobin's  $q$ ) amongst LargeCap firms, MidCap firms, and SmallCap firms. The sub-hypothesis from section 6.3.3 of Chapter 6 is re-stated as follows:

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<sup>10</sup> Hair, Anderson, Tatham, and Black (1998) comment that if the number of groups is small, the post hoc methods may identify the group differences (*ibid*, 1998, p. 356).

### Hypothesis H3b

H3b: There are systematic differences in the market valuation amongst LargeCap, MidCap, and SmallCap firms.

To supplement the test on the value relevance of disclosure (to be postulated in H3c and H3e in the subsection that follows), a two-tailed  $t$ -test of the difference between the two population means of Tobin's  $q$  (with population standard deviation  $\sigma$ 's unknown) is conducted as follows:

Let :

$Q_L$  = the mean of LargeCap firms' approximation of Tobin's  $q$ ;

$Q_M$  = the mean of MidCap firms' approximation of Tobin's  $q$ ;

$Q_S$  = the mean of SmallCap firms' approximation of Tobin's  $q$ .

ANOVA test is to use to test the null hypothesis, which is stated together with the alternative hypothesis for a two-tailed test, subject to the degree of freedom offered by the sample size of LargeCap, MidCap, and SmallCap firms, as follows:

#### Model 3.1a

$$H_0: Q_L - Q_M = 0$$

$$H_1: Q_L - Q_M \neq 0 \quad (\text{Model 3.1a})$$

#### Model 3.1b

$$H_0: Q_L - Q_S = 0$$

$$H_1: Q_L - Q_S \neq 0 \quad (\text{Model 3.1b})$$

#### Model 3.1c

$$H_0: Q_M - Q_S = 0$$

$$H_1: Q_M - Q_S \neq 0 \quad (\text{Model 3.1c})$$

Since the sample size changes in the years of study, the above-mentioned ANOVA test is applied across different groupings of firms on a year-by-year basis to see if there are any significant differences between the LargeCap, MidCap, and SmallCap firms.

### (iii) Value relevance of disclosure

The third aspect of Hypothesis 3 is related to the *strength* of the relationship between CG disclosure and firm valuation for various firms. It is hypothesized that the strength of relationship would differ across LargeCap, MidCap, and SmallCap firms; and calls for tests whether the strength differs systematically amongst them. As discussed in Section 6.3.3 in Chapter 6, the following three sub-hypotheses are postulated:

Hypothesis H3c

H3c: There are systematic differences in the strength of relationship between voluntary CG disclosure and firm valuation of LargeCap firms and MidCap firms.

Hypothesis H3d

H3d: There are systematic differences in the strength of relationship between voluntary CG disclosure and firm valuation of MidCap firms and SmallCap firms.

Hypothesis H3e

H3e: There are systematic differences in the strength of relationship between voluntary CG disclosure and firm valuation of LargeCap firms and SmallCap firms.

To test sub-hypotheses H3c, H3d, and H3e, a different approach is adopted. Firstly, three dummy variables, DV\_L, DV\_M, and DV\_S, are assigned to each firm of the LargeCap-, MidCap-, and SmallCap group respectively. A value '1' is assigned to the dummy variable if the firm belongs to its respective group, and '0' otherwise. Then the CGDscore of each sample firm is multiplied by the value of its respective dummy variable to form three types of interaction variables: CG\*D<sub>V\_L</sub>, CG\*D<sub>V\_M</sub>, and CG\*D<sub>V\_S</sub> for LargeCap, MidCap, and SmallCap firms respectively. These three sets of interaction variables should be able to demonstrate the *joint* effect of market capitalization membership and CGDscore for each sample firm. Table 8.6 below illustrates the construction of these three types of interaction variables:

**Table 8.6 Construction of interaction variables for LargeCap, MidCap, and SmallCap firms**

Market Capitalization	Dummy Variable	Interaction variable		
		LargeCap	MidCap	SmallCap
LargeCap CGDscore	DV_L	CG*D <sub>V_L</sub>	0	0
MidCap CGDscore	DV_M	0	CG*D <sub>V_M</sub>	0
SmallCap CGDscore	DV_S	0	0	CG*D <sub>V_S</sub>

Secondly, to test whether there are any systematic differences in the strengths of value relevance of voluntary disclosure of the firms due to their variations in market capitalization, a regression model is specified similar to Model 1.2 using *q* as the dependent variable, and choosing one of the three market capitalization groups as a base group. As the sample of LargeCap firms has the smallest sample size, it is selected as the base group. In addition to the same set of explanatory variables as in Model 1.2, two dummy variables (namely, DV\_M and DV\_S) and two interaction

variables (namely, CG\*D<sub>V</sub>\_M and CG\*D<sub>V</sub>\_S) will enter the new regression model as explanatory variables. The coefficients of D<sub>V</sub>\_M and D<sub>V</sub>\_S estimated from the regression model should be able to indicate the differences from the Intercept (i.e., the coefficient on Beta 0, which represents that of the D<sub>V</sub>\_L) and the significance of their difference. The coefficients of the interaction variables (i.e., CG\*D<sub>V</sub>\_M and CG\*D<sub>V</sub>\_S) thus estimated should indicate the difference in slope from that of the LargeCap firms for the MidCap and SmallCap firms respectively. A *t*-test on these coefficients should then be able to indicate whether there are systematic differences across the different market capitalization groups in terms of the value relevance of their voluntary disclosure (i.e., to test the three sub-hypotheses H3c, H3d, and H3e). The new regression model is specified as follows:

Model 3.2a

$$\begin{aligned}
 q_{i,t} = & \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \sum_{j=1}^k \beta_j \text{CGprac}_{i,t} + \sum_{m=1}^p \beta_m \text{ComChar}_{i,t} \\
 & + \beta_2 \text{D}_V\_M_{i,t} + \beta_3 \text{D}_V\_S_{i,t} + \beta_4 \text{CG}^* \text{D}_V\_M_{i,t} + \beta_5 \text{CG}^* \text{D}_V\_S_{i,t} \\
 & + \varepsilon_{i,t}
 \end{aligned}
 \tag{Model 3.2a}$$

where:

$q_{i,t}$ ,  $\text{CGDscore}_{i,t}$ ,  $\text{CGprac}_{i,t}$ ,  $\text{ComChar}_{i,t}$ ,  $\text{D}_V\_M_{i,t}$ ,  $\text{D}_V\_S_{i,t}$ ,  $\text{CG}^* \text{D}_V\_M_{i,t}$ , and  $\text{CG}^* \text{D}_V\_S_{i,t}$  are as previously defined;  $\beta_0, \beta_1 \dots \beta_5$  are parameter estimates;  $\beta_j, \beta_m$  are vectors;  $\varepsilon_{i,t}$  is the error term; subscript *i* denotes the firm *i* where  $i = 1, 2, 3 \dots, n$ ; subscript *t* denotes fiscal year where  $t = 1, 2, 3$ ; subscript  $k = 1, 2, \dots, 5$ ; and subscript  $p = 1, 2, \dots, 5$ .

As suggested by previous studies (e.g., Cheung, Stouraitis, and Wong, 2005), small firms are likely to have larger information asymmetry, compared to larger firms. The impact of voluntary disclosure by small firms is therefore likely to be different from that of larger firms. To test the above preposition, another model is set up specifically for the SmallCap firms (S) to compare with other firms, that is, the sample of LargeCap and MidCap combined (L+M). The SmallCap firm model, Model 3.2b, specified as follows, differs from Model 3.2a in that only the dummy variable D<sub>V</sub>\_S and the interaction variable CG\*D<sub>V</sub>\_S that are related to SmallCap firms enter the model, controlling for other variables:

### Model 3.2b

$$q_{i,t} = \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \sum_{j=1}^k \beta_j \text{CGprac}_{i,t} + \sum_{m=1}^p \beta_m \text{ComChar}_{i,t} + \beta_2 \text{DV\_S}_{i,t} + \beta_3 \text{CG*DV\_S}_{i,t} + \varepsilon_{i,t} \quad (\text{Model 3.2b})$$

where:

$q_{i,t}$ ,  $\text{CGDscore}_{i,t}$ ,  $\text{CGprac}_{i,t}$ ,  $\text{ComChar}_{i,t}$ ,  $\text{DV\_S}_{i,t}$ , and  $\text{CG*DV\_S}_{i,t}$  are as previously defined;  $\beta_0$ ,  $\beta_1 \dots \beta_3$  are parameter estimates;  $\beta_j$ ,  $\beta_k$  are vectors,  $\varepsilon_{i,t}$  is the error term; and subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3 \dots, n$ ; subscript  $t$  denotes fiscal year where  $t=1, 2, 3$ ; subscript  $k = 1, 2, \dots, 5$ ; and subscript  $p = 1, 2, \dots, 5$ .

## **8.8.6 Hypothesis 4 (H4)**

Hypothesis 4 (*H4*) is set on the relationship between the dividend payout (*DivPay*) and the CG disclosure of a firm. The dependent variable is dividend payout, while the independent variables are the CGDscores, company characteristics variables, and the control variables. For easy reference, H4 is repeated as follows:

### Hypothesis 4

*H4*: Under a strong legal protection regime, high corporate governance ranking firms have lower dividend payout ratios, *ceteris paribus*, than low corporate governance ranking firms.

Before H4 is tested, it is necessary to test if dividend payout can be affected by the CG disclosure, CG practices, and the performance characteristics specific to the sample firms. In similar fashion to Model 1.1, a preparatory model is constructed and applied to the L+M+S sample, the L+M sample, and the S sample as follows:

### Model 4.0

$$\text{DivPay}_{i,t} = \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \sum_{j=1}^k \beta_j \text{CGprac}_{i,t} + \beta_2 \text{Dir\%Own}_{i,t} + \varepsilon_{i,t} \quad (\text{Model 4.0})$$

where *DivPay* is the Dividend Payout ratio expressed in percentage; *CGDscore* and *Dir%Own* as previously defined in Model 1.0;  $\beta_0$ ,  $\beta_1$ , and  $\beta_2$  are parameter estimates,  $\beta_j$  is a vector for the parameters of the  $\text{CGprac}_{i,t}$  which is a family of variables that comprises five ( $k=5$ ) variables on CG practices:

- $\text{BoDSize}_{i,t}$  = total number of all director on the board of directors;

- NumINED<sub>*i,t*</sub> = the number of INEDs sitting on the board of directors;
- INED%<sub>*i,t*</sub> = the percentage of INEDs of the total number of directors;
- SplitRole<sub>*i,t*</sub> = a dummy variable ‘1’ for split role of CEO and Chairman, ‘0’ otherwise;
- DualList<sub>*i,t*</sub> = a dummy variable ‘1’ for cross listing on any other exchange, 0 otherwise; and

$\varepsilon_t$  is the error term; subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3 \dots, n$ ; subscript  $t$  denotes fiscal year where  $t = 1, 2, 3$ ; and subscript  $k = 1, 2, \dots, 5$ .

The objective of Model 4.0 is to identify the significant factors, if any, that may affect the level of Dividend Payout amongst the firms with various market capitalizations. Testing Model 4.0 with three samples of firms will also shed light on the differences, if any, among LargeCap, MidCap, and SmallCap firms in terms of their dividend payout levels. Hence, there will be three versions of Model 4.0, namely, Model 4.0\_LMS on the L+M+S sample, Model 4.0\_LM on the L+M sample, and Model 4.0\_S on the S sample, using the same variables but with different sample firms.

#### Model 4.1

In order to test H4, which postulates that the *ranking* of the firm’s CG disclosure may have an impact on its dividend payout, the 2x3 matrix similar to what is stated previously in Table 8.3 is adopted. The regression model for testing H4 is specified as follows:

$$\begin{aligned} \text{DivPay}_{i,t} = & \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \sum_{j=1}^k \beta_j \text{CGprac}_{i,t} + \sum_{m=1}^p \beta_m \text{ComChar}_{i,t} \\ & + \beta_2 \text{DV\_HM}_{i,t} + \beta_3 \text{DV\_HP}_{i,t} + \beta_4 \text{DV\_LL}_{i,t} + \beta_5 \text{DV\_LM}_{i,t} \\ & + \beta_6 \text{DV\_LP}_{i,t} + \varepsilon_{i,t} \end{aligned} \quad (\text{Model 4.1})$$

where:

DivPay<sub>*i,t*</sub> is the dividend payout ratio by firm  $i$  in year  $t$ ; CGDscore<sub>*i,t*</sub>, CGprac<sub>*i,t*</sub>, are as previously defined; DV\_HM<sub>*i,t*</sub>, DV\_HP<sub>*i,t*</sub>, DV\_LL<sub>*i,t*</sub>, DV\_LM<sub>*i,t*</sub>, and DV\_LP<sub>*i,t*</sub> are dummy variables as defined in Model 1.3; ComChar<sub>*i,t*</sub> denotes a set of company characteristic variables consisting of:

ROE<sub>*i,t*</sub> = return on equity;

LnSales<sub>*i,t*</sub> = natural log of a firm’s sales;

SalGrow<sub>*i,t*</sub> = Sales growth over previous year;

$\text{LnEqty}_{i,t}$  = natural log of a firm's equity;

$\text{Debt/TA}_{i,t}$  = debt ratio (i.e., Debt/Total Assets) expressed in percentage;

$\beta_0, \beta_1, \dots, \beta_6$  are parameter estimates;  $\beta_j, \beta_m$  are vectors;  $\varepsilon_{i,t}$  is the error term;

subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3, \dots, n$ ; subscript  $t$  denotes fiscal year

where  $t = 1, 2, 3$ ; subscript  $k = 1, 2, \dots, 5$ ; and subscript  $p = 1, 2, \dots, 5$ .

Model 4.1 will be applied to the three samples as shown previously in Table 8.5. Subject to the test results of the models on Hypothesis 3 (i.e., if it is empirically tested that no systematic differences exist between LargeCap and MidCap firms in both aspects of CG disclosure level and value relevance), the LargeCap firms can be pooled with the MidCap firms to form a bigger (L+M) sample for the purpose of testing H4. This is justifiable because previous research has suggested that larger firms (including medium-sized firms) tend to have more stable dividends-profits-and-retained-earnings relationship (Lintner, 1956, p. 113). Large and established firms tend to have a target payout ratio (Miller and Modigliani, 1961). These well-established firms tend to adjust dividends only marginally, primarily upward in response to their earnings increases (Fama and Babiak, 1968). Furthermore, larger and more profitable firms are more likely to pay dividends (Denis and Osobov, 2008). In sum, larger and more visible firms are likely to have a dividend policy different from that of small firms (Mitton, 2004). To control for any firm size effects within the same group of sample firms, the variable  $\text{LnEqty}_{i,t}$  (as included under the  $\text{ComChar}_{i,t}$  variable specified on the right hand side of Model 4.0), is retained in the model.

The established theories suggest that firms would try to avoid drastic fluctuations in dividend payout over years (i.e., 'dividend smoothing' as suggested by Renneboog and Trojanowski, 2007). Hence it appears that there is no loss of robustness if the 3 years' data are pooled into one sample frame for the purpose of testing hypotheses on the firm's dividend payouts. Similar to the treatment in Model 1.3, the sample frame of Model 4.0 for testing the dividend payout can be regrouped into three panels of firms: (i) pooled sample (L+M+S), (ii) combined sample of LargeCap and MidCap firms (L+M), and (iii) SmallCap sample (S). Model 4.0 is applied to each of these three panels. To specify the model for each panel, Model 4.0 is split into three sub-models as follows:



Model 4.1\_LMS

$$\begin{aligned} DivPay_{i,t} = & \beta_0 + \beta_1 BoDsize_{i,t} + \beta_2 NumINED_{i,t} + \beta_3 INED\%_{i,t} + \beta_4 SplitRole_{i,t} \\ & + \beta_5 DualList_{i,t} + \beta_6 ROE_{i,t} + \beta_7 LnSales_{i,t} + \beta_8 SalGrow_{i,t} \\ & + \beta_9 LnEqty_{i,t} + \beta_{10} Debt/TA_{i,t} + \beta_{11} DV\_HM_{i,t} + \beta_{12} DV\_HP_{i,t} \\ & + \beta_{13} DV\_LL_{i,t} + \beta_{14} DV\_LM_{i,t} + \beta_{15} DV\_LP_{i,t} + \varepsilon_{i,t} \quad (\text{Model 4.1\_LMS}) \end{aligned}$$

where  $DivPay_{i,t}$ ,  $BoDsize_{i,t}$ ,  $NumINED_{i,t}$ ,  $INED\%_{i,t}$ ,  $SplitRole_{i,t}$ ,  $DualList_{i,t}$ ,  $ROE_{i,t}$ ,  $LnSales_{i,t}$ ,  $SalGrow_{i,t}$ ,  $LnEqty_{i,t}$ , and  $Debt/TA_{i,t}$  are as previously defined;  $DV\_HM_{i,t}$ ,  $DV\_HP_{i,t}$ ,  $DV\_LL_{i,t}$ ,  $DV\_LM_{i,t}$ ,  $DV\_LP_{i,t}$  are dummy variables as defined in Model 1A;  $\beta_0, \beta_1 \dots \beta_{15}$  are parameter estimates;  $\varepsilon_{i,t}$  is the error term; subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3 \dots, n$ ; and subscript  $t$  denotes fiscal year where  $t = 1, 2, 3$ .

Model 4.1\_LMS is to be applied onto the pooled sample of LargeCap, MidCap, and SmallCap firms (L+M+S).

Model 4.1\_LM

$$\begin{aligned} DivPay_{i,t} = & \beta_0 + \beta_1 BoDsize_{i,t} + \beta_2 NumINED_{i,t} + \beta_3 INED\%_{i,t} + \beta_4 SplitRole_{i,t} \\ & + \beta_5 DualList_{i,t} + \beta_6 ROE_{i,t} + \beta_7 LnSales_{i,t} + \beta_8 SalGrow_{i,t} \\ & + \beta_9 LnEqty_{i,t} + \beta_{10} Debt/TA_{i,t} + \beta_{11} DV\_HM_{i,t} + \beta_{12} DV\_HP_{i,t} \\ & + \beta_{13} DV\_LL_{i,t} + \beta_{14} DV\_LM_{i,t} + \beta_{15} DV\_LP_{i,t} + \varepsilon_{i,t} \quad (\text{Model 4.1\_LM}) \end{aligned}$$

where all variables, dummy variables, parameter estimates, error term, and subscripts are same as defined in Model 4.1\_LMS. Model 4.1\_LM is to be applied onto the combined sample of LargeCap and MidCap firms (L+M).

Model 4.1\_S

$$\begin{aligned} DivPay_{i,t} = & \beta_0 + \beta_1 BoDsize_{i,t} + \beta_2 NumINED_{i,t} + \beta_3 INED\%_{i,t} + \beta_4 SplitRole_{i,t} \\ & + \beta_5 DualList_{i,t} + \beta_6 ROE_{i,t} + \beta_7 LnSales_{i,t} + \beta_8 SalGrow_{i,t} \\ & + \beta_9 LnEqty_{i,t} + \beta_{10} Debt/TA_{i,t} + \beta_{11} DV\_HM + \beta_{12} DV\_HP \\ & + \beta_{13} DV\_LL + \beta_{14} DV\_LM + \beta_{15} DV\_LP + \varepsilon_{i,t} \quad (\text{Model 4.1\_S}) \end{aligned}$$

where all variables, dummy variables, parameter estimates, error term, and subscripts are same as defined in Model 4.1\_LMS. Model 4.1\_S is to be applied onto the 3-year pooled sample of SmallCap firms (S).

### 8.8.7 Hypothesis 5 (H5)

Hypothesis 5 (H5) postulates that firms with insider ownership of 25% to 50% exhibit the lowest dividend payout ratio; because the probability of agency problem and the entrenchment problem occurring is likely to be the lowest at this range of insider ownership, *ceteris paribus* (as explained in Section 6.3.5 in Chapter 6). For quick reference, H5 is re-stated as follows:

#### Hypothesis 5

H5: Firms that have insider ownership of 25%-50% exhibit the lowest dividend payout ratio, compared to firms that have insider ownership of 0-25% or over 50%, *ceteris paribus*.

To put H5 into context, the 2x3 matrix table as stated in Table 8.3 is adopted. The empirical results derived from the tests conducted in Section 8.8.6 under Model 4.1\_LMS, Model 4.1\_LM, and Model 4.1\_S will indicate whether H5 can be accepted or rejected. Specifically, the models constructed to test H5 can be prescribed as follows:

#### Model 5.1

The coefficient of the dummy variable DV\_HM is less than that of DV\_HL and DV\_HP for Model 4.1\_LMS, Model 4.2\_LM, and Model 4.3\_S applying respectively onto the L+M+S, L+M, and S samples. (Model 5.1)

#### Model 5.2

The coefficient of the dummy variable DV\_LM is less than that of DV\_LL and DV\_LP for Model 4.1\_LMS, Model 4.2\_LM, and Model 4.3\_S applying respectively onto the L+M+S, L+M, and S samples. (Model 5.2)

## 8.9 Summary

Following Chapter 7 that covers the definitions of the explanatory and the dependent variables, this chapter explains the sample selection, data collection, methodology, and research design of this study. The first half of this chapter discusses the CG data collection process, the collection period, and the construction of the CG Disclosure Checklist, which is compiled with reference to *Appendix 23* of the *Listing Rules* of HKEx. It explains the computation of the CG disclosure index (the CGDscore), which is one of the key variables for the empirical models to be specified in this

study. The CGDscore is computed by assigning equal weights to each aspect of CG practices that are disclosed in the annual reports from 2003 to 2005, and scaled by the number of applicable questions on the checklist. A total of 258 annual reports are examined to obtain the CGDscores of these sample firms, which spread over the LargeCap, MidCap, and SmallCap constituent stocks of the HSHKCI Index. In order to obtain an overall picture about the pervasiveness of dual listing of the sample firms, data on their dual listing status are also collected from their annual reports.

The second half of this chapter is devoted to the research design, the elaboration on methodology, as well as the specification of models for the purpose of testing the hypotheses as stated in Chapter 6 previously. The models are to be tested with empirical results reported in Chapter 10. In the next chapter, Chapter 9, the descriptive statistics and the univariate analytical results of these variables are reported.

## Chapter 9: Descriptive Statistics and Univariate Analyses of Sample Firms

### 9.1 Introduction

This chapter presents the descriptive statistics about the sample firms in terms of the variables, which have been identified and defined in Chapter 7. The summary statistics of these variables are grouped according to the market capitalization of sample firms, namely, LargeCap firms, MidCap firms, and SmallCap firms; across the period of study (i.e., 2003-2005). As the purpose of this study is to investigate the relationship between the voluntary CG disclosures, market valuation, and dividend payout of the sample firms with respect to insider ownership, the key variables of interest in this study are:

- (1) corporate governance disclosure scores (CGDscore);
- (2) market valuation measure as proxied by Tobin's  $q$ ;
- (3) dividend payout ratio (DivPay); and
- (4) directors' ownership percentage (Dir%Own).

The summary statistics of above-mentioned key variables will be discussed in detail for each group of sampled firms. The descriptive statistics of other control variables used in the study are also discussed.

The structure of this chapter is as follows: Section 9.2 focuses on the descriptive statistics of LargeCap firms; Section 9.3 features those of MidCap firms; while Section 9.4 describes the same for SmallCap firms. Section 9.5 compares the differences amongst LargeCap, MidCap, and SmallCap firms in respect of the four key variables as mentioned above. The results of the univariate analyses of these sample firms are also presented in the same section. Section 9.6 concludes with a summary that highlights the significance of the statistics for each market capitalization category of sample firms.

### 9.2 Descriptive statistics of LargeCap firms

The summary statistics of LargeCap firms for each year of the study period 2003-2005 are presented in Table 9.1. Unlike MidCap and SmallCap firms, the sample size ( $N$ ) of LargeCap firms for the period remains unchanged at 12. In Panel A, the means for 2003 – 2005 are shown under columns 2 - 4; the medians for 2003 - 2005 are shown under

columns 5 - 7; and the standard deviations for 2003 - 2005 under columns 8 - 10 respectively. In Panel B, the minimum and maximum value of each variable are reported under columns 2-3 for 2003, under columns 4-5 for 2004, and under columns 6-7 for 2005. Table 9.2 shows the statistics for the pooled period.

**Table 9.1 Descriptive statistics of variables for LargeCap firms in 2003-2005**

**Panel A: Means, medians, and standard deviations of the variables for LargeCap firms (N=12 for each year of 2003-2005)**

	1	2	3	4	5	6	7	8	9	10
1	LargeCap	2003	2004	2005	2003	2004	2005	2003	2004	2005
		<b>Mean</b>			<b>Median</b>			<b>Standard Deviation</b>		
2	<i>q</i>	1.38	1.39	1.42	1.12	1.10	1.17	0.76	0.81	0.79
3	CGDscore	26.72	41.68	53.41	20.47	42.24	54.12	12.57	17.74	11.59
4	NumINED	4.25	4.83	4.83	4.00	4.50	4.00	1.82	1.64	1.53
5	BoDsize	14.92	15.17	15.83	15.50	15.50	15.00	3.09	3.30	3.88
6	INED%	29.06	32.80	31.73	28.34	31.37	30.38	14.49	11.69	11.01
7	Dir%Own	45.27	45.15	46.21	47.55	47.55	49.01	17.98	17.64	17.45
8	SplitRole*	0.67	0.83	0.75	1.00	1.00	1.00	0.49	0.39	0.45
9	DualList**	0.75	0.75	0.75	1.00	1.00	1.00	0.45	0.45	0.45
10	DivPay	61.06	52.05	42.80	56.11	51.99	46.12	17.15	20.12	13.42
11	ROE	8.71	10.43	16.26	6.07	7.94	14.82	6.01	5.43	8.71
12	LnSales	23.53	23.61	23.65	23.37	23.43	23.46	0.80	0.84	0.99
13	SalGrow	27.20	9.72	7.05	7.03	7.60	7.51	70.42	17.31	22.29
14	Ln(TA)	25.27	25.34	25.44	25.14	25.27	25.38	0.81	0.80	0.74
15	LnEqty	24.79	24.89	24.94	24.69	24.86	24.91	0.76	0.77	0.77
16	Debt/TA	25.62	24.11	26.66	23.84	22.29	25.46	13.58	13.00	13.32

**Panel B: Minimum and maximum values of the variables for LargeCap firms (N=12 for each year of 2003-2005)**

	1	2	3	4	5	6	7
1	LargeCap	2003		2004		2005	
		<b>Minimum</b>	<b>Maximum</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Minimum</b>	<b>Maximum</b>
2	<i>q</i>	0.90	3.68	0.93	3.85	0.92	3.86
3	CGDscore	15.18	51.06	17.70	72.30	29.33	74.85
4	NumINED	0.00	7.00	3.00	8.00	3.00	8.00
5	BoDsize	10.00	19.00	9.00	21.00	10.00	23.00
6	INED%	0.00	60.00	18.75	54.55	17.39	50.00
7	Dir%Own	0.07	71.88	0.06	71.88	0.07	71.75
8	SplitRole*	0.00	1.00	0.00	1.00	0.00	1.00
9	DualList**	0.00	1.00	0.00	1.00	0.00	1.00
10	DivPay	41.34	93.40	28.67	97.06	14.10	59.60
11	ROE	3.20	19.96	5.32	20.40	5.80	34.05
12	LnSales	22.71	25.38	22.63	25.63	22.49	25.93
13	SalGrow	-10.61	246.30	-12.48	43.49	-49.21	35.65
14	Ln(TA)	23.80	27.15	23.88	27.18	24.11	27.09
15	LnEqty	23.53	26.23	23.58	26.29	23.52	26.22
16	Debt/TA	9.31	51.92	10.20	51.58	7.65	52.40

Notes:

\* Dummy variable with value 1= split roles of Chairman and CEO, 0 = otherwise.

\*\* Dummy variable with value 1 = dual listed, 0 = otherwise.

**Table 9.2 Descriptive statistics of variables for LargeCap firms in 2003- 2005**  
(N= 36)

2003-2005 LargeCap	Mean	Median	Std Dev	Minimum	Maximum
<i>q</i>	1.40	1.13	0.77	0.90	3.86
CGDscore	40.60	44.03	17.70	15.18	74.85
Num INED	4.64	4.00	1.64	0.00	8.00
BoDsize	15.31	15.00	3.36	9.00	23.00
INED%	31.19	29.41	12.23	0.00	60.00
Dir%Own	45.54	49.01	17.19	0.06	71.88
SplitRole*	0.75	1.00	0.44	0.00	1.00
DualList**	0.75	1.00	0.44	0.00	1.00
DivPay	51.97	49.89	18.26	14.10	97.06
ROE	11.80	8.12	7.43	3.20	34.05
LnSales	23.60	23.42	0.86	22.49	25.93
SalGrow	14.66	7.15	43.49	-49.21	246.30
Ln(TA)	25.35	25.27	0.76	23.80	27.18
LnEqty	24.87	24.80	0.75	23.52	26.29
Debt/TA	25.46	23.28	12.96	7.65	52.40

Notes:

\* Dummy variable with value 1= split roles of Chairman and CEO, 0=otherwise.

\*\* Dummy variable with value 1 = dual listed, 0=otherwise.

Some comments on the variables of LargeCap firms with respect to their statistics in Table 9.1 and 9.2 are provided as follows:

(i) Market valuation as proxied by Tobin's *q*

Market valuation of firm is proxied by the approximation of Tobin's *q* (as discussed in Section 7.2.1 of Chapter 7). From row 2, columns 2 to 4, of Table 9.1, it can be seen that the mean of *q* for all LargeCap firms in the study had increased slightly over the period of study, at 1.38, 1.39 and 1.42 for the years 2003, 2004, and 2005 respectively. There is not much change in the medians, observed as 1.12, 1.10, and 1.17 for the three years (as shown in row 2, columns 5-7 of Table 9.1), which cluster around 1.10. The standard deviation also remains closely to each other at 0.76, 0.81, and 0.79 over the three years (row 2, columns 8-10 of Table 9.1). Thus, it could be interpreted that the market valuation (*q*) of LargeCap firms did not seem to change a lot during the study period.

(ii) CG Disclosure Score (CGDscore)

Unlike *q*, CGDscore of LargeCap firms spreads over a wide range, indicating that there is a big difference in the levels of disclosure on CG practises. Table 9.1 (Panel B, row 3) shows that the minimum CGDscores for years 2003, 2004, and 2005 are respectively 15.18 (row 3, column 2), 17.7 (row 3, column 4), and 29.33 (row 3, column 6). It suggests that LargeCap firms that were scarcely disclosing their CG practices in the early years turned to do so in 2005. However, comparing with a possible score of 100, the minimum score of

29.33 (row 3, column 6) is still far from satisfactory. The maximum score is 51.06 in 2003, 72.3 in 2004, and 74.85 in 2005 (Table 9.1, Panel B, row 3). It shows that some LargeCap firms started to increase their CG disclosure in 2004, and kept on increasing its disclosure further in 2005.

The improvement in CG disclosure is particularly noticeable in 2004. The median of the CGDscores indicates that 50% of LargeCap firms had a CGDscore of 20.47 in 2003, 42.24 in 2004, and 54.12 in 2005 (Table 9.1, Panel A, row 3, columns 5-7). It suggests that one half of LargeCap firms had a CGDscore above 20.47 in 2003, but this threshold had risen to 54.12 by 2005. It seems that a big progress on CG disclosures was made in 2004. On average, LargeCap firms disclosed more and more over the years: the mean of CGDscore (Table 9.1, row 3, columns 2-4) is 26.72 in 2003, 41.68 in 2004 (or 56.0% year-on-year increase), and 53.41 in 2005 (or 28.1% increase). For the 3-year pooled period of study, the average mean CGDscore is 40.60 (Table 9.2, row 3, column 2).

Assessing the CG disclosure scores in association with the firm valuation proxied by  $q$  for LargeCap firms, it is noticeable that the sharp increase in CGDscore is accompanied by only a mild increase in  $q$ . In theory, sales growth could be causing an increase in firm valuation. In practice, a declining trend of average sales growth across the years is actually observed for the study period – the mean sales growth rates of LargeCap firms are 27.2%, 9.72%, and 7.05% respectively for 2003, 2004 and 2005 (Table 9.1, Panel A, row 13, columns 2 - 4). In order to find out the association between CGDscore and other variables of LargeCap firms, a Pearson correlation analysis is carried out, with results discussed in sub-section (viii) below.

#### (iii) Director Ownership (Dir%Own)

It is observed from Table 9.1, Panel B, row 7, columns 2-7, that Director Ownership (Dir%Own) ranges from 0.07% to 71.88% in the three years of study. With such a wide range of values, it would be more meaningful to examine the median rather than the mean of these director ownership levels. As shown in Table 9.1, Panel A, row 7, columns 5-7, the median Dir%Own is 47.55 in 2003 and 2004, but rises to 49.01 in 2005. These statistics show that half of the LargeCap firms in the period of study had a director ownership above 47.55%, and half of them had an ownership below 47.55%. The median had risen slightly to 49.01 in 2005. In terms of total firm-years during the pooled period, the median Dir%Own is at 49.01% (Table 9.2, row 7, column 3 refers). In sum, there is hardly any great change in director ownership (Dir%Own) over the three years. For firms

with large market capitalization, an insider ownership of 49% is quite high compared to similar diffusely owned firms in the U.S. and U.K., but such high insider ownership is common in Asia. This finding is consistent with the empirical results reported by Chau and Gray (2002) whose sample shows a mean insider ownership of 44% for Hong Kong firms; and 43% for Singapore firms.

(iv) Dividend Payout (DivPay)

Dividend payout ratio (DivPay) is defined as the dividend per share divided by earnings per share and expressed in percentage. As discussed in Section 7.2.2 in Chapter 7, there are many theories for paying dividends; and correspondingly many rationales for the dividend payout ratios. For Hong Kong listed firms, their dividend payout ratios vary greatly. In the sample period, some firms did not pay at all; some firms paid historically the same level of dividend payout rate; and some firms paid a token dividend even when they reported a loss in profits. For LargeCap firms, DivPay fluctuates from 41.43% - 93.40% in 2003, 28.67% - 97.06% in 2004, to 14.10% - 59.60% in 2005 (Table 9.1, Panel B, row 10). The median DivPay is 56.11%, 51.99%, and 46.12% respectively for 2003, 2004 and 2005, which indicates that half of LargeCap firms paid out approximately half of their profits as dividends in years 2003 and 2004 (Table 9.1, Panel A, row 10, columns 5-7) but they cut their payout ratio severely below 50% for year 2005, probably due to the downturn in the Hong Kong economy then. In the 3-year pooled period, the average DivPay ratio is 51.97% (Table 9.2, row 10, column 2), which is similar to that of MidCap firms (51.37%, see Section 9.3 below) but is considerably higher than SmallCap firms (42.47%, see Section 9.4 below). The overall dividend payout ratio is therefore not excessively low or high, judging from the fact that most LargeCap firms in the sample are long-established companies that might have passed the rapid growth stage in their business life cycles.

La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV, 2000b) posit that in a weak legal protection environment where expropriation of shareholders' wealth can easily be achieved by insiders, firms will be eager to establish a good reputation for moderation in expropriating shareholders' wealth, so as to make it easier to raise external funds from investors at a later stage. Paying high dividends is one way to establish such a reputation. In Hong Kong, there is prima facie evidence that LargeCap firms do not pay an excessively high dividend rate, probably because the outside shareholders have not exercised their legal rights to demand a high payout (as in LLSV's outcome model); or the inside shareholders do not consider it necessary to use high dividends to protect their reputation against the alleged expropriation of minority shareholders.



(v) Dual Listing (DualList)

Reese and Weisback (2002) argue that managers of firms that decide to cross-list signal to the market a reduction of their private benefit. Hence, cross listing can be construed, and perceived, as an indicator of an enhanced level of corporate governance for a firm. As discussed in Chapter 4 (Section 4.2.4), in terms of investor protection, the choice of listing location of a firm has a signalling effect. Klapper and Love (2004) state that reporting standards and investor protection in the U.S. are much higher than in most other countries. Therefore, firms would be required to improve their corporate governance provisions in order to list on the U.S. stock exchanges. In the current sample of LargeCap firms (N=12 firms), eight firms (67%) have cross-listing status, mostly with the second market being American Depositary Receipt (ADR) in the U.S. Two of them cross-listed in a third market at London Exchange or Tokyo Exchange (Appendix 1). The corporate governance standards of those LargeCap firms having cross-listed standings (67%) are therefore likely to meet the expectations of investors and be acceptable to the regulators in that foreign exchange.

(vi) Split Role of Chairman and Chief Executive Director (SplitRole)

The state of corporate governance in a firm can be visibly observed in two variables, namely, the roles of Chairman and the Chief Executive Officer (CEO) if split (i.e., SplitRole) and the percentage of independent directors on the board (INED%). In this study, the duality of Chairman and CEO of the sample firms is measured with a dummy variable (SplitRole) with value equals '1' to denote their roles are split and '0' otherwise. For the sample of LargeCap firms, the mean of SplitRole is 0.67 for year 2003, 0.83 for year 2004, and 0.75 for year 2005 (Table 9.1, Panel A, row 8, columns 2-4). These dummy variable values show that in a majority of the LargeCap firms, the roles of Chairman and CEO are carried out by two different persons. The practice of splitting the Chairman and CEO had become more popular, as indicated by the increased values of the mean of the dummy variable from two-thirds in 2003 to three quarters in 2005. For the 3-year study period, the mean is 0.75. It can be interpreted, therefore, that most LargeCap firms had split their roles in Chairman/CEO for most of the time in the study period.

(vii) Percentage of Independent Executive Directors on the Board of Directors (INED%)

The presence of independent non-executive directors (INEDs) is a necessary condition for exerting effective monitoring of a firm tightly owned by insiders, particularly by family owners (as discussed in Section 3.3.4 of Chapter 3). To outside investors, the composition

of the board in a family-owned firm may indicate the willingness of the family members to share their power with non-family members in decision-making. The proportions of INEDs among all directors on the board can proxy for the emphasis that an insider-owned firm would place on addressing its corporate governance issues. In this study, the number of the INEDs as a percentage of the board of directors (INED%) is a quantitative CG measurable that can be observed objectively. Generally speaking, the higher the INED%, the more likely the insiders are to be effectively monitored by the INEDs. Nevertheless, it should be pointed out that this study only considers the *quantitative* aspect of corporate governance. In the event that independent directors are compromised by insiders, leading to a failure to perform their fiduciary duties to investors to the fullest extent, there is no iron-clad correlation that a high INED% may correspond with a high *quality* of CG practice within the firm. In that case, there is still likelihood for the outside investors' wealth to be expropriated.

In the sample of LargeCap firms, the INED%, though steadily rising, does not increase much over the years. As shown in Table 9.1, Panel A, row 6, columns 5-7, the median INED% is 28.34% in 2003, rises to 31.37% in 2004, and slightly declines to 30.38% in 2005. However, in 2003, there had been cases where no INED was serving on the board of directors for some LargeCap firms (Table 9.1, Panel B, row 6, column 2). The scarcity of INEDs started to improve in 2004, and had reached 18.75% in 2004 (Table 9.1, Panel B, row 5, column 4) from 0 in year 2003 (Table 9.1, Panel B, row 5, column 2) before it diminished slightly to 17.39% in 2005 (Table 9.1, Panel B, row 6, column 6). On the other hand, the maximum INED% showed a decrease from 60% in 2003 to 50.00% in 2005 (Table 9.1, Panel B, row 6). In terms of the pooled firm-years over the 3-year study period, the mean INED% is 31.19%, which is lower than the recommended level stipulated in *Appendix 14* of the *Listing Rules* (i.e., at least one-third of the board). If outsiders used the statistics to judge whether there are sufficient INEDs on the board to carry out the monitoring function, the statistics are not particularly satisfactory because the overall percentage of INEDs had not reached the desirable level as proposed in the principle of board composition stated in *Appendix 14* of the *Listing Rules*.

#### (viii) Correlations between the key variables

A Pearson correlation analysis is conducted for the variables of corporate governance to test whether there is any significant association between one variable and the other for the LargeCap sample. The results are presented in Table 9.3, with the Pearson coefficients shown in each cell of the table with the *p*-value provided underneath. From Table 9.3,

column 2, it can be seen that the coefficient of correlation between  $q$  and CGDscore is negative (-0.109) but not significant ( $p$ -value = 0.528). Hence, it can be argued that CGDscore does not seem to be strongly correlated with  $q$  for LargeCap firms (at 0.05 alpha level). However, CGDscore is correlated ( $p$ -value < 0.10) with the following corporate governance variables (Table 9.3, column 3):

- (i) NumINED – the number of Independent Non-Executive Directors (positively);
- (ii) INED% – the percentage of INED on the board of directors (positively);
- (iii) SplitRole – the roles of CEO and Chairman are split (positively);
- (iv) DualList – the dual-listing status of the firm (positively);

and is strongly correlated ( $p$ -value < 0.05) with the following control variables (Table 9.3, column 3):

- (v) ROE – return on equity (positively);
- (vi) LnSales – the natural log of sales (positively); and
- (vii) Debt/TA – Debt/Total Assets (positively).

The results suggest that, the larger the profitability and sales turnover, and the greater the leverage, the higher will be the voluntary disclosure of the LargeCap firms as expressed in terms of CGDscore. This is consistent with Capital Markets Transactions Hypothesis (Section 4.3.1 of Chapter 4) that a reputable, large-scale, firm tends to be more transparent in order to satisfy the information needs of its stakeholders including its creditors, suppliers, and customers.

As regards the Dividend Payout ratio (DivPay), the downward trend of DivPay for LargeCap firms during the study period 2003-2005 (as shown in Table 9.1, row 10, columns 2-4) does not seem to have a strong correlation with the decline in the firms' sales growth (SalGrow), as the Pearson Correlation between DivPay and SalGrow in Table 9.3 (row 12, column 10) shows that the  $p$ -value is larger than 0.05. However, Dividend Payout is correlated with the following CG practices variables (Table 9.3, row 9):

- (i) NumINED – Number of INEDs (negatively);
- (ii) INED% – Percentage of INEDs on the board (negatively);
- (iii) DualList – Dual listing status (positively);

and strongly correlated with the following control variables (Table 9.3, column 10):

- (iv) LnTA – Size of total assets (negatively);
- (v) LnEqty – Size of the firm's equity (negatively).

The correlation coefficients of DivPay with these variables suggest that the Independent Non-Executive Directors do not seem to endorse LargeCap firms in disgorging more dividend payments. On the other hand, the dual listing status of the firm is positively associated with the level of Dividend Payout, suggesting a cross listed LargeCap firm is often associated with distributing a higher proportion of earnings as dividends to investors, both domestic and overseas.

It should be pointed out that a correlation test does not consider the joint effect of all the variables on  $q$ , or on Dividend Payout. A regression analysis will be a better method to identify the determinants of  $q$  and Dividend Payout, controlling for other firm-related variables. This will be covered in Chapter 10: Regression analysis. The frequency distribution charts of  $q$ , CGDscores, Director Ownership of equity, and Dividend Payout ratios for the pooled period of 2003-2005 are shown in Figures A.1- A.4 respectively in **Appendix 3** of this thesis.

**Table 9.3 2003-2005 LargeCap Firms Variables Correlations**

	<i>q</i>	CGDscore	NumINED	BoDsize	INED%	Dir%Own	SplitRole	DualList	DivPay	ROE	LnSales	SalGrow	LnTA	LnEqty	Debt/TA
CGDscore	-0.109 (0.528)														
NumINED	<b>-0.362*</b> (0.030)	<b>0.301</b> (0.074)													
BoDsize	<b>0.470**</b> (0.004)	-0.001 (0.996)	<b>0.279</b> (0.099)												
INED%	-0.093 (0.590)	<b>0.302</b> (0.074)	<b>0.784**</b> (0.000)	<b>-0.339*</b> (0.043)											
Dir%Own	-0.157 (0.362)	-0.191 (0.264)	-0.274 (0.106)	<b>0.419*</b> (0.011)	<b>-0.559**</b> (0.000)										
SplitRole	0.225 (0.188)	<b>0.315</b> (0.061)	0.149 (0.387)	-0.276 (0.104)	0.226 (0.185)	-0.272 (0.108)									
DualList	<b>-0.396*</b> (0.017)	<b>0.328</b> (0.051)	<b>-0.367*</b> (0.028)	0.111 (0.518)	<b>-0.342*</b> (0.041)	0.114 (0.508)	-0.185 (0.280)								
DivPay	0.161 (0.348)	-0.221 (0.195)	<b>-0.406*</b> (0.014)	-0.068 (0.693)	<b>-0.290</b> (0.086)	0.017 (0.923)	-0.079 (0.647)	<b>0.317</b> (0.059)							
ROE	<b>0.605**</b> (0.000)	<b>0.348*</b> (0.037)	-0.138 (0.421)	-0.242 (0.155)	0.009 (0.958)	-0.121 (0.482)	0.249 (0.142)	-0.178 (0.299)	-0.174 (0.310)						
LnSales	-0.222 (0.193)	<b>0.337*</b> (0.045)	-0.236 (0.166)	-0.044 (0.800)	-0.277 (0.102)	<b>0.371*</b> (0.026)	0.164 (0.339)	<b>0.431**</b> (0.009)	-0.028 (0.873)	-0.175 (0.308)					
SalGrow	-0.089 (0.608)	-0.155 (0.367)	0.054 (0.752)	0.081 (0.640)	-0.032 (0.854)	-0.031 (0.855)	0.165 (0.337)	-0.227 (0.183)	-0.154 (0.370)	-0.122 (0.477)	0.094 (0.584)				
LnTA	<b>-0.634**</b> (0.000)	0.137 (0.427)	0.201 (0.239)	0.252 (0.138)	-0.007 (0.970)	0.023 (0.896)	-0.058 (0.735)	0.206 (0.228)	<b>-0.372*</b> (0.025)	<b>-0.493**</b> (0.002)	<b>0.548**</b> (0.001)	0.227 (0.182)			
LnEqty	<b>-0.625**</b> (0.000)	0.045 (0.795)	<b>0.294</b> (0.082)	<b>0.306</b> (0.069)	0.045 (0.793)	-0.047 (0.787)	-0.151 (0.379)	0.088 (0.610)	<b>-0.410*</b> (0.013)	<b>-0.520**</b> (0.001)	<b>0.359*</b> (0.031)	0.249 (0.143)	<b>0.957**</b> (0.000)		
Debt/TA	-0.086 (0.617)	<b>0.333*</b> (0.048)	-0.235 (0.168)	-0.220 (0.198)	-0.092 (0.592)	0.076 (0.661)	<b>0.393*</b> (0.018)	<b>0.352*</b> (0.035)	0.116 (0.502)	-0.005 (0.977)	<b>0.690**</b> (0.000)	-0.014 (0.934)	<b>0.288</b> (0.088)	0.008 (0.963)	
PTBV	<b>0.982**</b> (0.000)	-0.029 (0.868)	<b>-0.353*</b> (0.035)	<b>-0.454**</b> (0.005)	-0.092 (0.593)	-0.140 (0.414)	0.260 (0.126)	<b>-0.361*</b> (0.031)	0.137 (0.427)	<b>0.678**</b> (0.000)	-0.186 (0.277)	-0.085 (0.622)	<b>-0.635**</b> (0.000)	<b>-0.653**</b> (0.000)	0.000 (1.000)

(Notes: *p*-values are shown in brackets. Coefficients are bold if *p*-value < 0.10; \* if *p*-value < 0.05; \*\* if *p*-value < 0.01. PTBV denotes the Price-to-Book Value of Equity of firms)

## 9.3 Descriptive statistics of MidCap firms

### 9.3.1 Introduction

There are 29 MidCap sample firms in this study as at 2005. Two firms in the sample of 2005, namely, Foxconn International and Hutchison Telecom, were only listed in 2005. There is no publicly available data for these two firms in 2003. The accounting data for Hutchison Telecom became available starting 2004, but the data for Foxconn International were still missing. As a result, the number of MidCap firms in the study is reduced to 27 in 2003, 28 in 2004, and 29 in 2005. Total number of firm-years for the MidCap firms in the study period is therefore 84.

Some treatment to the data collected has been performed prior to compiling the summary statistics. They are presented below:

- (i) Some MidCap firms are found to have negative equity in the sample in 2003 and 2004. The firm concerned, PCCW, underwent a leverage buyout in 2000. As a negative equity means no equity for the firm, the entire case of the firm is deleted from the sample. The number of firms in the study is reduced to 26 firms in 2003, and 27 in 2004.
- (ii) There are firms that distributed dividend per share (DPS) in excess of earnings per share (EPS) in the study period. There are two circumstances. Firstly, there are firms that distribute more dividend per share than they earned per share during that fiscal year. In that case, the firms were paying the dividends from their retained earnings accumulated from previous years. Secondly, there are firms that suffered a loss in earnings in some fiscal years but still paid a dividend. In both cases, one can view from a dividend signalling perspective that these firms are indicating that the reduced earnings (or loss) is a temporary phenomenon. Either that the management is confident that the performance of the firm will turn around very soon, or that the reserve in the firm is more than sufficient to cover the expenses for the dividend paid. In such cases, there are no current earnings for the firms to transfer to the reserve. The position is equivalent to the position of a firm where all its current year's earnings have been distributed as dividends, i.e. Dividend Payout at 100%. To avoid inadvertent distortions to the overall summary statistics and the follow-on regression analyses, Dividend Payout ratio for firms

distributing DPS in excess of EPS is taken to be 100%; and those dividend-paying firms that had actually incurred a loss (or a negative EPS) but paid dividend are also treated as paying 100% dividend payout ration. Similar treatment is applied to other SmallCap firms in this study if same circumstances arise. As no LargeCap firms had shown zero or negative dividend payout, there is no need to cap or adjust the DivPay for them.

The summary statistics of MidCap firms after adjustment of capping is used for analysis in this chapter.

### 9.3.2 Summary Statistics of MidCap firms

Summary statistics of the means, medians, and standard deviations of the variables for MidCap firms in 2003, 2004 and 2005 are presented in Table 9.4 (Panel A), while the minimum and maximum values of the variables are presented in Table 9.4 (Panel B). The statistics of the variables for the 3-year pooled sample are shown in Table 9.5. The frequency distributions of the four CG variables, namely,  $q$ , CGDscores, Dividend Payouts (DivPay), and Director's Ownership (Dir%Own) for MidCap firms for the years 2003, 2004 and 2005 are shown at Figures 9.5- 9.8 in Appendix 5.

**Table 9.4 Descriptive statistics of variables for MidCap firms in 2003-2005**

**Panel A: Means, Medians and Standard Deviations of the variables of MidCap firms.**

N varies with year.

	1	2	3	4	5	6	7	8	9	10
1	LargeCap	2003	2004	2005	2003	2004	2005	2003	2004	2005
		<b>Mean</b>			<b>Median</b>			<b>Standard Deviation</b>		
2	$q$	1.86	1.86	2.12	1.21	1.23	1.51	1.52	1.45	1.67
3	CGDscore	30.50	42.89	62.32	26.15	37.50	68.33	14.90	22.94	23.04
4	NumINED	3.15	3.81	3.93	3.00	3.00	3.00	1.26	1.75	1.62
5	BoDsize	11.23	11.30	11.52	11.00	12.00	12.00	3.20	3.11	3.03
6	INED%	30.09	35.38	34.33	27.92	33.33	33.33	13.03	15.16	14.58
7	Dir%Own	52.47	52.37	51.41	55.38	54.69	54.34	17.10	17.34	18.11
8	SplitRole*	0.73	0.81	0.72	1.00	1.00	1.00	0.45	0.40	0.45
9	DualList**	0.23	0.26	0.28	0.00	0.00	0.00	0.43	0.45	0.45
10	DivPay	63.07	51.35	40.91	66.60	46.51	38.00	29.52	26.68	31.33
11	ROE	12.23	15.65	21.90	9.81	10.97	18.22	11.95	13.62	14.77
12	LnSales	22.38	22.67	22.86	22.16	22.60	22.73	1.09	1.10	1.17
13	SalGrow	184.10	41.33	13.93	11.88	21.83	9.42	883.36	80.77	27.05
14	Ln(TA)	23.74	23.87	24.00	23.79	23.93	23.96	0.84	0.82	0.80
15	LnEqty	23.11	23.26	23.26	23.32	23.42	23.51	0.85	0.85	1.00
16	Debt/TA	27.16	24.32	24.57	27.81	25.51	21.28	17.08	18.24	22.81

**Table 9.4 Descriptive statistics of variables for MidCap firms in 2003-2005****Panel B: Minimum and Maximum values of the variables of MidCap firms. N varies with year.**

	1	2	3	4	5	6	7
1	LargeCap	2003		2004		2005	
		Minimum	Maximum	Minimum	Maximum	Minimum	Maximum
2	<i>q</i>	0.69	5.63	0.69	6.02	0.76	6.85
3	CGDscore	15.15	62.30	15.38	94.64	20.31	98.18
4	NumINED	0.00	6.00	2.00	11.00	3.00	11.00
5	BoDsize	5.00	19.00	6.00	19.00	6.00	17.00
6	INED%	0.00	55.56	16.67	84.62	3.28	84.62
7	Dir%Own	0.15	84.82	0.46	84.82	0.80	84.82
8	SplitRole*	0.00	1.00	0.00	1.00	0.00	1.00
9	DualList**	0.00	1.00	0.00	1.00	0.00	1.00
10	DivPay	14.39	100.00	0.00	100.00	0.00	100.00
11	ROE	-9.64	33.41	-1.94	48.99	-5.12	68.33
12	Ln(Sales)	20.50	24.48	20.30	24.58	20.33	24.74
13	SalGrow%	-29.43	4513.90	-27.89	410.53	-37.31	92.07
14	Ln(TA)	21.63	25.48	21.73	25.44	21.84	25.53
15	LnEqty	21.37	24.55	21.50	24.72	20.23	24.84
16	Debt/TA%	0.00	65.05	0.00	67.35	0.00	97.97

Notes:

Number of firms (N): = 26 firms in 2003; 27 firms in 2004; 29 firms in 2005

\* Dummy variable with value 1= split roles of Chairman and CEO, 0=otherwise.

\*\* Dummy variable with value 1 = dual listed, 0=otherwise.

**Table 9.5 Descriptive statistics of variables for MidCap firms in 2003- 2005****(N= 82)**

	1	2	3	4	5	6
1	2003-2005 MidCap	Mean	Median	Std Dev	Minimum	Maximum
2	<i>q</i>	1.95	1.25	1.54	0.69	6.85
3	CGDscore	45.83	40.63	24.43	15.15	98.18
4	NumINED	3.65	3.00	1.58	0.00	11.00
5	BoDsize	11.35	11.00	3.08	5.00	19.00
6	INED%	33.33	33.33	14.31	0.00	84.62
7	Dir%Own	52.06	54.60	17.33	0.15	84.82
8	SplitRole*	0.76	1.00	0.43	0.00	1.00
9	DualList**	0.26	0.00	0.44	0.00	1.00
10	DivPay	51.37	42.72	29.03	0.00	100.00
11	ROE	16.77	13.43	13.99	-9.64	68.33
12	LnSales	22.64	22.60	1.13	20.30	24.74
13	SalGrow	76.91	13.53	498.72	-37.31	4513.90
14	Ln(TA)	23.87	23.95	0.82	21.63	25.53
15	LnEqty	23.21	23.42	0.90	20.23	24.84
16	Debt/TA	25.31	25.31	19.45	0.00	97.97

Notes:

\* Dummy variable with value 1= split roles of Chairman and CEO, 0=otherwise.

\*\* Dummy variable with value 1 = dual listed, 0=otherwise.

Observations and commentary are made in the following sub-sections.



(i) Firm valuation as proxied by  $q$

The mean of Tobin's  $q$  for all MidCap firms remains stable in 2003 and 2004 ( $q = 1.86$ ) and increases by 13% (2.12) in 2005 (Table 9.4, Panel A, row 2, columns 2-4). For the 3-year study period, the mean  $q$  for MidCap firms is 1.95 (Table 9.5, row 2, column 2), which is higher than LargeCap firms (3-year mean  $q = 1.40$  as per Table 9.2, row 2, column 2). Hence, the Tobin's  $q$  for MidCap firms is generally larger than that of LargeCap firms, despite that MidCap firms are classified as having a lower market value in terms of market capitalization (as defined by the HSHKCI index series). The market *valuation* of firms (as proxied by Tobin's  $q$ ), therefore, may not correspond to the market *capitalization* of firms. This relationship will be tested in Chapter 10.

(ii) CGDscore

As shown in row 3, Panel B of Table 9.4, the minimum of CGDscore of MidCap firms does not change much in the first two years (15.15 in 2003, 15.38 in 2004) but improves greatly to 20.31 in 2005. It indicates that some MidCap firms did not pay much attention to disclosing their CG practices, or they were reluctant to do so. However, at the maximum end of the CGDscore spectrum, significant improvement is observed for firms that had already implemented CG practices – the maximum CGDscore rises from 62.3 in 2003, to 94.64 in 2004, and 98.18 in 2005 (Table 9.4, Panel B, row 3, columns 3, 5, and 7 refer). The median of CGDscore also rises from 26.15 in 2003, 37.5 in 2004, to 68.33 in 2005. The improvement is significant in the year 2005, with an increase of 82% (Table 9.4, Panel A, row 3, columns 5-7). It suggests that more and more MidCap firms became aware of the need to disclose their CG practices in that year.

The mean of CGDscore per MidCap firm increases with time too – from 30.5 in 2003 to 42.89 in 2004 (up 40%), and 62.32 in 2005 (up 45 %), as shown in Panel A of Table 9.4 (row 3, columns 2-4). It seems that there was a significant improvement in the adoption of corporate governance mechanisms and practices in 2005. As at 2005, the mean of CGDscore for MidCap firms is 62.32 (Table 9.4, Panel A, row 3, column 4), which is even higher than that of LargeCap firms (53.41, as shown in Table 9.1, Panel a, row 3, column 4). The mean of CGDscore over the pooled 3-year period is 45.83 (Table 9.5, row 3), which is also higher than the LargeCap firms (40.6, as shown in Table 9.2, row 3). In short, more Midcap firms had disclosed their CG practices than LargeCap firms (probably due to a larger sample size).

Also, on average, the MidCap firms were disclosing more about their CG practices than their LargeCap counterparts over the period 2003-2005.

(iii) Director Ownership (Dir%Own)

For the sample period in this study, the median Director Ownership (Dir%Own) for MidCap firms varies narrowly around 55% (Table 9.4, Panel A, row 7, columns 5-7). The mean Director Ownership for each year also clusters around 52%, although the span of equity ownership is rather wide – it ranges from a minimum of 0.15% in 2003 (Panel B, row 7, column 2), to a maximum of 84.82% in 2004 and 2005 (Panel B, row 7, columns 5 & 7). As shown in row 7, column 2 of Table 9.5, the 3-year mean Dir%Own for MidCap firms is 52.06%, which is larger than that of LargeCap firms (45.54%, as shown in Table 9.2, column 2). When compared to LargeCap firms, MidCap firms are characterised by a higher insider ownership, which is consistent with the findings in prior literature (e.g., Leung and Horwitz, 2004). The preponderance of a majority insider ownership (> 50%) for the MidCap firms is probably due to the fact that, generally, it takes lesser financial resources to acquire a higher share of equity for medium firms than for large firms.

(iv) Dividend Payout ratio (DivPay)

The Dividend payout ratios for MidCap companies vary from firm to firm. The statistics show that there are firms that do not pay any dividend at all (minimum= 0), and there are firms that pay dividend per share equal to or in excess of earnings per share, or pay dividend while EPS is negative (in which cases, it will be capped at 100% at maximum as explained in Section 9.3.1). Half of MidCap firms have a Dividend Payout ratio (DivPay) at or over 66.60% in 2003, but the median DivPay steadily declines to 46.51% in 2004 and 38% in 2005 (Table 9.4, Panel A, row 10). The mean Dividend Payout ratio has decreased quite rapidly during the study period, suggesting an absence of a stable Dividend Payout policy within MidCap firms. (It should also be noted that the declining trend happens for LargeCap firms too, whose median DivPay falls from steadily from 56% in 2003, 52% at 2004, to 46% at 2005, as per Table 9.1, Panel A, row 10). Compared to LargeCap firms, the 3-year average DivPay for MidCap firms firm-years is 51.37%, which is similar to LargeCap firms (51.97%). According to La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV, 2000b), paying higher dividends is one method for the insider owners to establish a reputation for moderation in expropriating shareholders' wealth. This argument may hold true for MidCap firms whose average insider ownership (52.06%) is higher than that of LargeCap firms

(45.54%, as per previous subsection). Further evidence is needed before any conclusions are made on the pattern of Dividend Payout ratios of the sample firms.

(v) Dual Listing (DualList)

Cross listing is yet another indicator of an enhanced level of corporate governance for a firm, as discussed in a similar section under LargeCap firms in this Chapter. It is found in Table 9.4, Panel A, row 9 that there is a much lower percentage of MidCap firms that are cross-listed in another exchange (the means are 0.23, 0.26, and 0.28 for 2003, 2004, and 2005 respectively, as per Table 9.4, Panel A, row 9), as compared to LargeCap firms (mean remains unchanged at 0.67 for 2003-2005). In 2005, eight MidCap firms cross-listed on other stock exchanges, one at London Stock Exchange and seven at ADR or NYSE in the U.S. For those eight firms that are subject to the accounting standards and regulations of U.K. and U.S., there is likelihood for more corporate governance practices being implemented in the firms. However, cross listing on another exchange often involves high costs. Firms would not seek cross listing unless they are certain that cross listing will bring about overseas capital to help develop their business further. In fact, not all MidCap firms can successfully raise foreign capital by cross-listing; and conversely, many MidCap firms can successfully raise capital without cross-listing. Hence, cross listing alone is not the only factor that determines the state of CG for MidCap firms. Other variables, such as splitting the roles of the Chairman from the CEO's, may need to be taken into consideration.

(vi) Split Role of Chairman and CEO (SplitRole)

For the sample of MidCap firms, the mean value for SplitRole is 0.73, 0.81, and 0.72 for 2003-2005 respectively (Table 9.4, Panel A, row 8, columns 2-4). It shows that, on average, the role of Chairman and the role of CEO for a MidCap firm are split; and that the proportion of MidCap firms with SplitRole changes only slightly over the 3 years. This proportion is comparable to the state of LargeCap firms, where the mean is recorded as 0.67 in 2003, 0.83 in 2004 and 0.75 in 2005 (Table 9.1, Panel A, row 8). Over the 3-year study period, the mean for SplitRole is 0.76 for MidCap firms (Table 9.5, row 8, column 2), similar to 0.75 for LargeCap firms (Table 9.2, row 8, column 2). The split role of Chairman and CEO is promulgated by HKEx under the code provision, which is a mandatory requirement of the *Listing Rules*. Yet, by end of 2005, there were still about one fourth of the firms on average with the functions of Chairman and CEO performed by the same person.

(vii) Percentage of Independent Executive Directors on a Board of Directors (INED%)

In the sample of MidCap firms, the medians for INED% are 27.92, 33.33, and 33.33 for 2003, 2004 and 2005 respectively (Table 9.4, Panel A, row 6, columns 5-7), which is comparable to those for LargeCap firms (28.34, 31.37, and 30.38 for 2003-2005 respectively as shown in Table 9.1, Panel A, row 6, columns 5-7). Yet, in 2003, there were MidCap firms with no INED appointed (as shown in Table 9.4, Panel B, row 6, column 2). The minimum INED% increased to 16.67% in 2004 but dropped again to 3.28% in 2005 (Table 9.4, Panel B row 6, column 4 and column 6). On the other hand, the maximum INED% had increased from 55.56 in 2003, to 84.62 in both 2004 and 2005 (Table 9.4, Panel B, row 6, columns 3, 5, and 7). The statistics indicate that, for those firms without INEDs appointed previously, the management was struggling with the concept of installing INEDs in the firm, or was having difficulty in identifying suitable candidates as INEDs. For those firms at the other end of the spectrum, a higher percentage of INED% installed in year 2004 and 2005 reflects an assumption that a continual emphasis had been placed on the role of INEDs in corporate governance by the management of MidCap firms. In short, some MidCap firms appointed more and more INEDs over the 3-year period, while other MidCap firms did not. There is a diversity of importance attached to the role of INEDs amongst the MidCap firms. Over the 3-year study period, the mean INED% is 33.33, just enough to meet the *Listing Rule's* requirements.

(viii) Correlations between the key variables

As discussed earlier in this section, the mean of Tobin's  $q$  of all MidCap firms remained stable in 2003 and 2004 ( $q = 1.86$ ) but increased by 13% ( $q = 2.12$ ) in 2005. Yet, the year-on-year increase of the mean CGDscore is 40% (i.e., 42.89/30.5) in 2004 and 45% (i.e., 62.32/42.89) in 2005. Table 9.6 presents a correlation test of the pooled variables for the MidCap firms from 2003 to 2005. From Table 9.6 (row 2, column 2), it can be seen that no significant correlation is found between CGDscore and  $q$  ( $p$ -value  $> 0.10$ ). However, it is found that CGDscore is strongly and significantly ( $p$ -value  $< 0.05$ ) correlated with the following corporate governance variables (Table 9.6, column 3):

- (i) NumINED – number of INEDs (positively);
- (ii) INED% – percentage of INEDs on the board (positively);
- (iii) Dir%Own – percentage of Director Ownership (negatively).

In terms of control variables, the MidCap firms' CG disclosure score is positively correlated with profitability (ROE). This is similar to LargeCap firms. However, MidCap firms' CGDscore is not correlated with LnSales or Debt Ratio (Debt/Total Assets).

As regards Midcap firms' Dividend Payout (DivPay), it is highly and significantly correlated ( $p$ -value  $< 0.01$ ) with market valuation  $q$  (Table 9.6, row 9, column 2). DivPay is also strongly correlated ( $p$ -value  $< 0.05$ ) with the following corporate governance variables (Table 9.6, row 9):

- (i) NumINED – number of INEDs (positively);
- (ii) INED% – percentage of INEDs on the board (positively);
- (iii) SplitRole – the role of CEO and Chairman is split (positively); and
- (iv) Dir%Own – percentage of Director Ownership (negatively).

Such correlation is similarly found in the variables for the LargeCap firms. However, the signs are different for the number of INEDs and the percentage of INEDs on the board. It seems that the presence of INEDs on the board of directors has a different impact on LargeCap firms than the MidCap firms.

To sum up, there is a significant year-on-year change of CGDscores for MidCap firms' from 2003 to 2005, similar to the case of LargeCap firms. The  $q$ 's, however, do not show any significant changes. As regards Dividend Payouts, the MidCap firms show a gradual but not significant change from 2003 to 2004, but the significant *decrease* in the Dividend Payout from 2003 to 2005 is notable. Similar to the case of LargeCap firms, Director Ownership in respect of MidCap firms does not show any significant differences over the 3 years, which is also consistent with prior literature (e.g., Leung and Horwitz, 2004).

**Table 9.6 2003-2005 MidCap Firms Variables Correlations**

	<i>q</i>	CGDscore	NumINED	BoDsize	INED%	Dir%Own	SplitRole	DualList	DivPay	ROE	LnSales	SalGrow	LnTA	LnEqty	Debt/TA
CGDscore	0.043 (0.702)														
NumINED	0.088 (0.433)	<b>0.354**</b> (0.001)													
BoDsize	-0.157 (0.160)	0.050 (0.655)	0.176 (0.114)												
INED%	<b>0.186</b> (0.094)	<b>0.267*</b> (0.015)	<b>0.769**</b> (0.000)	<b>-0.419**</b> (0.000)											
Dir%Own	-0.161 (0.149)	<b>-0.232*</b> (0.036)	<b>-0.332**</b> (0.002)	-0.116 (0.299)	<b>-0.234*</b> (0.034)										
SplitRole	<b>0.184</b> (0.099)	0.146 (0.192)	0.179 (0.107)	<b>0.344**</b> (0.002)	-0.052 (0.646)	-0.153 (0.170)									
DualList	0.168 (0.132)	-0.050 (0.657)	-0.063 (0.571)	-0.086 (0.442)	-0.016 (0.888)	<b>-0.212</b> (0.055)	-0.057 (0.610)								
DivPay	<b>0.288**</b> (0.009)	0.009 (0.934)	<b>0.233*</b> (0.035)	0.098 (0.380)	<b>0.193</b> (0.083)	<b>-0.407**</b> (0.000)	<b>0.290**</b> (0.008)	-0.151 (0.175)							
ROE	<b>0.650**</b> (0.000)	<b>0.207</b> (0.062)	0.137 (0.218)	-0.078 (0.484)	0.161 (0.148)	-0.168 (0.133)	0.017 (0.881)	0.108 (0.336)	0.058 (0.602)						
LnSales	<b>0.245*</b> (0.027)	0.151 (0.176)	0.001 (0.996)	-0.156 (0.161)	0.083 (0.457)	0.108 (0.335)	-0.127 (0.254)	-0.110 (0.324)	-0.045 (0.687)	<b>0.337**</b> (0.002)					
SalGrow	-0.053 (0.637)	-0.078 (0.485)	-0.048 (0.666)	-0.040 (0.723)	-0.033 (0.765)	0.061 (0.586)	0.068 (0.544)	-0.071 (0.527)	-0.150 (0.179)	0.027 (0.810)	0.006 (0.955)				
LnTA	<b>-0.776**</b> (0.000)	0.102 (0.363)	0.051 (0.651)	0.055 (0.626)	-0.024 (0.831)	0.144 (0.198)	<b>-0.195</b> (0.079)	-0.122 (0.275)	<b>-0.276*</b> (0.012)	<b>-0.506**</b> (0.000)	0.087 (0.437)	0.030 (0.787)			
LnEqty	<b>-0.671**</b> (0.000)	-0.103 (0.357)	-0.138 (0.217)	-0.049 (0.061)	-0.114 (0.309)	<b>0.384**</b> (0.000)	-0.167 (0.134)	-0.172 (0.123)	<b>-0.334**</b> (0.002)	<b>-0.689**</b> (0.000)	-0.144 (0.198)	-0.035 (0.757)	<b>0.792**</b> (0.000)		
Debt/TA	<b>-0.440**</b> (0.000)	0.028 (0.806)	-0.144 (0.196)	0.013 (0.910)	-0.137 (0.219)	0.092 (0.413)	<b>-0.258*</b> (0.020)	0.096 (0.389)	-0.162 (0.145)	-0.067 (0.549)	<b>0.356**</b> (0.001)	0.170 (0.128)	<b>0.434**</b> (0.000)	0.005 (0.961)	
PTBV	<b>0.355**</b> (0.001)	<b>0.222*</b> (0.045)	<b>0.253*</b> (0.022)	0.151 (0.176)	0.122 (0.274)	<b>-0.277*</b> (0.012)	0.109 (0.330)	<b>0.229*</b> (0.038)	<b>0.204</b> (0.066)	<b>0.652**</b> (0.000)	<b>0.242*</b> (0.028)	-0.036 (0.751)	-0.174 (0.117)	<b>-0.637**</b> (0.000)	<b>0.241*</b> (0.029)

(*p*-values are shown in brackets. Coefficients are **bold** if *p*-value < 0.10; \* if *p*-value < 0.05; \*\* if *p*-value < 0.01. PTBV denotes Price-to-Book Value of Equity of firms)

## 9.4 Descriptive statistics of SmallCap firms

### 9.4.1 Introduction

There are 50 SmallCap firms in the Hang Seng Hong Kong Composite SmallCap Index (HSHKCSI) as at 5 September 2005, the cut-off date for selection of sample firms. Two firms on the HSHKCSI were subsequently removed from the sample, for reason that (i) no annual reports are available for extracting raw data in 2003 and 2005 for China Resources Peoples Telephone<sup>1</sup>; and (ii) the reporting period is less than a 12-month period for one year for Pacific Century Premium Development<sup>2</sup>; rendering it inappropriate to include the data in the study. Hence there are 48 SmallCap firms for study in 2005.

Four firms<sup>3</sup> were only listed in 2005 and there is no publicly available data for the two firms in 2003. As a result, the number of SmallCap firms under study in 2003 is reduced to 44. With 48 firms in 2004, and 48 firms in 2005, the total number of firm-years in the SmallCap sample study is 140.

Some treatment to the data collected has been performed prior to compiling the summary statistics. Three firms<sup>4</sup>, CNAC, Far East Consortium, and Wheelock Property, distributed dividends despite making a loss in 2003. There was a negative value for the Dividend Payouts (i.e., DPS divided by EPS and expressed in terms of %). Following the treatment made previously for similar cases for MidCap firms (Section 9.3.1), the Dividend Payout is taken to be 100% for those loss making but dividend paying firms. Another firm<sup>5</sup>, SCMP Group, distributed dividend per share in excess of earnings per share. In line with the treatment for similar cases of MidCap firms, its Dividend Payout is capped at 100%.

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<sup>1</sup> China Resources Peoples Telephone was listed on 2004 and delisted on 28/3/2006. No annual report was issued for 2003 and 2005.

<sup>2</sup> Pacific Century Premium Development changed its fiscal year in 2004 due to re-organisation and major change of business nature. The annual report for 2004 was shorter than the normal 12 months period.

<sup>3</sup> The four companies are Lifestyle International Holdings, Luen Thai Holdings, Pacific Basin Holdings, and Solomon Systech International.

<sup>4</sup> CNAC: EPS = HK\$(0.00566) loss in 2003; DPS = HK\$0.009. The other two firms are: Far East Consortium: EPS = HK\$(0.13) loss in 2003; DPS = HK\$0.02; and Wheelock Property: EPS = HK\$(0.378) loss in 2003; DPS = HK\$0.07.

<sup>5</sup> SCMP Group, recorded a very small profit in 2003 (EPS = HK\$0.0011) and paid a DPS at HK\$0.06 per share, making the dividend payout ratio exceeding high at 5455%.

### 9.4.2 Summary statistics of SmallCap firms

Summary statistics for SmallCap firms for the individual years of 2003, 2004 and 2005 are presented in Table 9.7 Panel A and Panel B, while the statistics in terms of the pooled 3-year period for the study are shown in Table 9.8 below. The frequency distributions of the four variables of corporate governance, namely,  $q$ , CGDscores, Director's Ownership, and Dividend Payouts, for SmallCap Firms for the years 2003, 2004 and 2005 are respectively shown as Figures A1.3, A2.3, A3.3, and A.4.3 in Appendix 3 of this study.

**Table 9.7 Descriptive statistics of variables for SmallCap firms in 2003 -2005**

**Panel A: Means, Medians and Standard Deviations of the variables of MidCap firms.**

**N varies with year (see notes).**

SmallCap	2003	2004	2005	2003	2004	2005	2003	2004	2005
	Mean			Median			Standard Deviation		
$q$	1.21	1.59	1.45	1.04	1.18	1.18	0.80	1.15	0.86
CGDscore	25.61	35.42	57.91	23.76	30.51	62.71	8.05	16.56	19.28
NumINED	2.66	3.21	3.35	3.00	3.00	3.00	1.08	0.92	0.70
BoDsize	9.18	9.77	9.83	9.50	10.00	10.00	2.63	2.61	2.48
INED%	30.80	34.07	36.13	28.57	34.52	34.85	13.27	11.32	11.04
Dir%Own	52.59	50.97	49.06	57.04	55.60	51.98	17.11	18.04	19.87
SplitRole*	0.41	0.46	0.60	0.00	0.00	1.00	0.50	0.50	0.49
DualList**	0.20	0.19	0.19	0.00	0.00	0.00	0.41	0.39	0.39
DivPay	46.68	43.15	37.94	44.82	44.86	33.33	32.50	25.67	27.39
ROE	10.21	18.35	19.96	9.23	12.76	17.05	11.33	22.15	17.08
LnSales	21.27	21.44	21.55	21.42	21.43	21.55	1.03	0.96	0.92
SalGrow	33.32	33.52	30.84	7.34	14.25	10.91	93.08	68.23	120.30
Ln(TA)	22.13	22.23	22.41	21.94	22.13	22.28	0.84	0.79	0.85
LnEqty	21.91	21.99	22.16	21.90	21.87	22.07	0.75	0.71	0.79
Debt/TA	17.34	18.76	18.85	11.79	14.00	18.28	16.22	17.05	16.46

**Panel B: Minimum and Maximum values of the variables of SmallCap firms**

**N varies with year (see Notes).**

SmallCap	2003		2004		2005	
	Minimum	Maximum	Minimum	Maximum	Minimum	Maximum
$q$	0.34	4.04	0.40	6.37	0.53	4.49
CGDscore	15.38	52.46	12.12	78.69	20.00	89.83
NumINED	0.00	6.00	0.00	5.00	2.00	5.00
BoDsize	4.00	15.00	4.00	15.00	6.00	18.00
INED%	0.00	60.00	0.00	60.00	16.67	66.67
Dir%Own	0.97	74.74	1.07	74.81	1.71	78.73
SplitRole*	0.00	1.00	0.00	1.00	0.00	1.00
DualList**	0.00	1.00	0.00	1.00	0.00	1.00
DivPay	0.00	100.00	0.00	100.00	0.00	100.00
ROE	-11.77	42.83	-5.85	130.52	-12.60	91.49
LnSales	18.50	23.55	18.73	24.09	18.91	24.39
SalGrow	-39.97	504.14	-43.69	332.46	-83.28	799.35
Ln(TA)	20.33	24.16	20.90	24.36	21.00	24.60
LnEqty	20.33	23.52	20.79	23.79	20.83	24.21
Debt/TA	0.00	56.30	0.00	63.56	0.00	72.11

Notes: Total number of firms is 44 in 2003; 48 in 2004; and 48 in 2005.

\* Dummy variable with value 1= split roles of Chairman and CEO, 0=otherwise.

\*\* Dummy variable with value 1 = dual listed, 0=otherwise.



**Table 9.8 Adjusted summary statistics of SmallCap firms in 2003-2005.**

2003-2005 SmallCap	Mean	Median	Std Dev	Minimum	Maximum
<i>q</i>	1.42	1.13	0.96	0.34	6.37
CGDscore	40.05	31.68	20.54	12.12	89.83
NumINED	3.09	3.00	0.95	0.00	6.00
BoDsize	9.61	10.00	2.57	4.00	18.00
INED%	33.75	33.33	11.99	0.00	66.67
Dir%Own	50.82	55.59	18.33	0.97	78.73
SplitRole*	0.49	0.00	0.50	0.00	1.00
DualList**	0.19	0.00	0.40	0.00	1.00
DivPay	42.47	40.88	28.57	0.00	100.00
ROE	16.34	12.58	17.95	-12.60	130.52
LnSales	21.42	21.48	0.97	18.50	24.39
SalGrow	32.54	11.70	95.65	-83.28	799.35
Ln(TA)	22.26	22.13	0.83	20.33	24.60
LnEqty	22.03	21.92	0.75	20.33	24.21
Debt/TA	18.34	14.35	16.48	0.00	72.11

Notes: Number of counts for each of the variables: 140

\* Dummy variable with value 1= split roles of Chairman and CEO, 0=otherwise.

\*\* Dummy variable with value 1 = dual listed, 0=otherwise.

*(i) Firm valuation as proxied by *q**

The mean of Tobin's *q* for all SmallCap firms fluctuates during the study period, from 1.21 in 2003, it rises to 1.59 in 2004 but falls to 1.45 in 2005 (Table 9.7, Panel A, row 2). Amongst the three categories of sampled firms, SmallCap firms exhibit the most volatile pattern of market valuation as proxied by *q*. The spread of *q* for SmallCap firms also differs from year to year: it ranges between 0.34 - 4.04 in 2003; 0.40 - 6.37 in 2004; and 0.53 - 4.49 in 2005 (Table 9.7, Panel B, row 2).

*(ii) CGDscore*

For the sample of SmallCap firms, there is a wide range between the minimum and the maximum CGDscore for the three-year study. The lowest score is 12.12 in 2004, and the highest score is 89.83 in 2005. The minimum value of the score has not improved much over time (15.38 in 2003, 12.12 in 2004, and 20.00 in 2005, as shown in Table 9.7, Panel B, row 3, columns 2, 4, and 6), showing that CG mechanisms and practices installed in those firms are quite limited. However, at the maximum end of the disclosure continuum, substantial increase in disclosure is detected for firms that had already practised corporate governance, with the rise of the maximum CGDscore from 52.46 in 2003, 78.69 in 2004, to 89.93 in 2005 (Table 9.7, Panel B, row 3, columns 3,5, and 7). The median of the CGDscores for all firms rises from 23.76 in 2003, 30.51 in 2004, to 62.71 in 2005 (Table 9.7, Panel A, row 3, column 5-7). The rising medians indicate that, generally, the 50<sup>th</sup> percentile of SmallCap firms are

disclosing more CG practices with years, with substantial increase in disclosure in 2005 (the median CGDscore in 2005 rises by 105% over that in 2004).

The mean of CGDscore also rises with time, from 25.61 in 2003 to 35.42 in 2004 (up 38%), and to 57.91 in 2005 (up 62 %), as shown in Table 9.7, Panel A, row 3, column 2-4). Like MidCap firms discussed previously in this chapter, a significant improvement in adopting corporate governance mechanisms and practices has been made in 2005. As at 2005, the mean of CGDscore for SmallCap firms is at 57.91, compared to 62.32 of MidCap firms and 53.41 of LargeCap firms. In terms of the pooled 3-year study period, the mean of CGDscore is 40.05 for SmallCap firms (Table 9.8, row 3, column 2). SmallCap firms' 3-year average disclosure is the lowest, compared to LargeCap firms (40.60) and MidCap firms (45.83). Overall speaking, the average CGDscore of SmallCap firms is more similar to LargeCap than to MidCap firms.

(iii) Director Ownership (Dir%Own)

The percentage of Director Ownership of SmallCap firms remains high (i.e. 3-year median = 55.59%, as shown in Table 9.8, row 7, column 3), indicating that more than half of SmallCap firms have always been owned by insiders who have collectively a predominant ownership. However, the ownership has decreased steadily over the years, with median Dir%Own at 57.04%, 55.60%, and 51.98% for 2003 - 2005 respectively (Table 9.7, Panel A, row 7, columns 5-7). The mean ownership by insiders has also fallen year on year, from 52.59%, 50.97%, to 49.06 in 2003-2005 (Table 9.7, Panel A, row 7, columns 2-4). The range of Director's Ownership fluctuates from as low as 0.97 in 2003 to a high of 78.73 in 2005 (Table 9.7, Panel B, row 7). Over the 3-year study period, the mean of Director's Ownership for SmallCap firms is 50.82% (Table 9.8, row 7, column 2), which is lower than that of MidCap firms (52.06% as in Table 9.5) but higher than that of LargeCap (45.54%, as in Table 9.2). This is in line with the findings by previous researchers (e.g., Leung and Horwitz, 2004) and consistent with the notion that it would be easier to obtain a predominant shareholding for smaller firms than for larger firms, as such a predominant ownership requires lesser financial costs.

(iv) Dividend Payout ratio (DivPay)

In the sample of SmallCap firms, the Dividend Payout ratios vary with firms. The summary statistics (Table 9.7, Panel B, row 10) show that there are firms that do not pay any dividend at all (minimum is 0); there are firms that pay dividend per share in excess of earnings per

share (capped at 100% in this study); and there are firms that pay dividend while making a loss (Dividend Payout ratio is taken to be 100% in this study). Half of SmallCap firms have a Dividend Payout ratio (DivPay) at or over 44.82%, 44.86%, and 33.33% respectively in 2003 - 2005 (Table 9.7, Panel A, row 10, columns 5-7). The mean of DivPayout drops steadily over the same period, from 46.68%, 43.15%, to 37.94% in 2003-2005 (Table 9.7, Panel A, row 10, columns 2-4). The average Dividend Payout ratio has been decreasing during the study period, although at a slower pace than MidCap firms (63.07%, 51.35%, and 40.91% in 2003- 2005; as shown in Table 9.4, Panel A, row 10). The 3-year average DivPay for SmallCap firms is 42.47% (Table 9.8, row 10, column 2). Compared with the other two groups of firms in this study, SmallCap firms record the lowest DivPay.

As mentioned earlier, La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV, 2000b) posit that paying higher dividends is one way for the insider owners to establish a reputation for moderation in expropriating shareholders' wealth. This argument does not seem to fit the case of SmallCap firms, as they make a relatively low DivPay to their shareholders compared to MidCap or LargeCap firms. Yet, at the same time, SmallCap firms had a higher insider (director) ownership. Taking both DivPay and Dir%Own into consideration, one may argue that the outside minority shareholders are powerless to demand for a higher dividend payout where a predominant shareholder is present. Therefore, it would be an empirical issue to investigate how these firms that are predominantly owned would fare in terms of market valuation  $q$ , controlling for other company characteristics such as profitability, sales growth, and leverage. Such relational analysis will be the focus of Chapter 10.

#### (v) Dual Listing (DualList)

Cross listing is an indicator of an enhanced level of corporate governance for a firm, as discussed earlier in Section 9.2 of this Chapter. There are nine SmallCap firms out of 48 firms in 2005 that are cross-listed, all at ADR in the U.S. As cross listed firms are subject to an additional, and usually more stringent, set of regulations and accounting standards in the U.S., it is expected that their corporate governance structure is better than their counterparts that are not cross-listed. The lowest percentage of cross listing is found in SmallCap firms (0.19), as shown in row 9 of Table 9.8, when compared to MidCap firms (0.26) and LargeCap firms (0.67). As discussed earlier in a similar sub-section for MidCap firms, the high cost incurred in cross listing and the required resources to meet additional scrutiny by another stock exchange/ regulatory institution may be too prohibitive for SmallCap firms.

Therefore, it may be argued that the status of cross listing, *ex post*, may not be appropriate to infer the *ex ante* state of corporate governance for SmallCap firms due to the endogenous costs involved. Other variables may have to be considered for determining the state of corporate governance of SmallCap firms.

(vi) Split Role of Chairman and CEO (SplitRole)

As discussed in similar sub-sections for LargeCap firms and MidCap firms, the state of corporate governance in a firm can be reflected in two variables, namely, the split of Chairman and CEO (SplitRole) and the percentage of Independent Directors on the board (INED%). A board led by a Chairman who is separate from the CEO is generally regarded as able to exert effective control over the management. Therefore, the role of the Chairman and CEO should be split and performed by two separate persons.

For the sample of SmallCap firms, the mean of the SplitRole dummy variable is less than half in 2003 (= 0.41) and 2004 (=0.46) but increases sharply in 2005 (= 0.60) (Table 9.7, Panel A, row 8). It seems to suggest that SmallCap firms were only willing to comply with the imminent regulation to split the roles towards the later part of the period. As such, the overall 3-year average value for SplitRole dummy variable is 0.49 (Table 9.8, row 8), which is less than the expected average level (0.5) and the 3-year average for MidCap firms (0.76) and LargeCap firms (0.75). It shows that less than half of the firms have the roles of Chairman and CEO carried out by two different persons. This suggests that the split roles of Chairman and CEO in SmallCap firms are relatively uncommon. In view that the split role of Chairman and CEO was going to be mandatory requirement in the *Listing Rules*, a great number of SmallCap firms still had to adjust to the new structure as required.

(vii) Percentage of Independent Executive Directors on a Board of Directors (INED%)

As explained in similar sections under LargeCap and MidCap firms, the presence of Independent Non-Executive Directors (INEDs) is expected to be able to exert effective monitoring of a family firm (Chapter 3, Section 3.3.4). In this study, the percentage of INEDs on the board of directors (INED%) is used as a proxy for the corporate governance in a firm. The higher the INED%, the more importance is given to corporate governance by the board of a firm and a more effective monitoring of insiders is inferred.

In the sample of SmallCap firms, the medians for INED% are 28.57%, 34.52% , and 34.85% for 2003-2005 (Table 9.7, Panel A, row 6, columns 5-7), which is comparable to the medians for MidCap firms (27.92%, 33.33%, and 33.33% for 2003- 2005) and LargeCap firms (28%, 31%, and 30% for 2003- 2005). In 2003 and 2004, some SmallCap firms had appointed no INED at all (Table 9.7, Panel B, row 6, columns 2 and 4). The minimum for INED% jumps to 16.67% in 2005 (Table 9.7, Panel B, row 6, column 6). As splitting the roles of Chairman and CEO is a code to be mandated by the *Listing Rules* to take effect in 2005, this pattern shows that some SmallCap firms would delay implementing this code provision as long as possible. When the predominant insider ownership is put into the context, the reluctance of these SmallCap firms to comply with the requirement of INED appointment is clear.

Furthermore, the maximum percentages of INED for the SmallCap firms over the period of study are 60.00%, 60.00% and 66.67% for 2003-2005 (Table 9.7, Panel B, row 6, columns 3,5, and 7), which do not show any substantial increase in the first two years. It therefore lends support to the notion that there is reluctance in SmallCap firms to appoint more outsiders to the board of directors of the firm. As compared to the drastic increase of the maximum of INED% for MidCap firms for the same period (increased from 55.56% in 2003, to 84.62% in 2004 and 2005), the SmallCap firms are more conservative about the appointment of INED to the board of directors. Overall, the mean INED% for SmallCap firms over the 3-year period is 33.75% (Table 9.8, row 6, column 1), which is slightly higher than what is expected or required by the HKEx.

#### (viii) Correlations between the key variables

There is a noticeable year-on-year change in the average CGDscore for SmallCap firms from 2003 to 2005 (mean CGDscore is 25.61, 35.42, and 57.91 in 2003- 2005 as shown in Table 9.7, Panel A, row 3). However, an increase in  $q$  is only registered from 2003 to 2004; and there is a slight decrease in  $q$  in 2005 (mean  $q$  is 1.21, 1.59, and 1.45 for 2003-2005 as shown in Table 9.7, Panel A, row 2). As indicated in previous sections, the market valuation of firm as proxied by  $q$  does not necessarily equal the market capitalization of firms. To explore the potential relationship between  $q$  and other variables, a regression model should be used. Before testing the relationship, a correlation test between the variables is necessary. Table 9.9 presents the Pearson correlation results of the variables of SmallCap firms. As shown in row 2 of Table 9.9, CGDscore is found to be positively correlated with  $q$  and the correlation is fairly significant ( $p\text{-value} = 0.067$ ). It seems to suggest that, for SmallCap firms, voluntary

disclosure of their corporate governance is positively associated with their firm valuation. Such positive association is not found in LargeCap or MidCap firms. SmallCap firms, therefore, may be quite different from LargeCap and MidCap firms in terms of the value relevance of CG disclosure. Other corporate governance variables with which the CGDscore of SmallCap firms is significantly correlated are:

- (i) NumINED – number of INEDs (positively);
- (ii) BoDsize – the size of the board of directors (positively);
- (iii) SplitRole – the role of CEO and Chairman is split (positively); and
- (iv) Dir%Own – the percentage of equity owned by directors (negatively)

As regards the control variables, the SmallCap firms' CGDscore is highly and significantly correlated with profitability (i.e., ROE). The  $p$ -value is 0.005 (Table 9.9, row 10, column 3). This is very similar to the case of LargeCap firms ( $p$ -value = 0.037, as per Table 9.3) and MidCap firms ( $p$ -value = 0.062, as per Table 9.6). It suggests that a profitable firm is associated with a firm that tends to be transparent with its CG disclosure.

A correlation test between the two market valuation measurements,  $q$  and Price-to-Book ratio, is also conducted to check whether these proxies are substitutes or compliments in the regression analyses. If they are highly correlated, then using either  $q$  or Price-to-Book ratio as the dependent variable in the structural model will yield similar findings and interpretations. From the correlation Tables 9.3, 9.6 and 9.9, it can be seen that  $q$  and Price-to-Book Value of equity ratios (PTBV) are significantly and positively correlated for all the LargeCap, MidCap and SmallCap firms. Therefore, both measures are robust in measuring the firms' market valuation. Following previous research (e.g., Black, Jang and Kim, 2006; Brown and Caylor, 2006; Bebchuk, Cohen and Ferrell, 2008), this study uses  $q$  instead of Price-to-Book Value of Equity ratio as proxy for the market valuation of sample firms.

**Table 9.9 2003-2005 SmallCap Firms Variables Correlations**

	<i>q</i>	CGDscore	NumINED	BoDsize	INED%	Dir%Own	SplitRole	DualList	DivPay	ROE	LnSales	SalGrow	LnTA	LnEqty	Debt/TA
CGDscore	<b>0.155</b> (0.067)														
NumINED	-0.012 (0.888)	<b>0.285**</b> (0.001)													
BoDsize	-0.097 (0.252)	<b>0.180*</b> (0.034)	<b>0.244**</b> (0.004)												
INED%	0.065 (0.446)	0.106 (0.213)	<b>0.652**</b> (0.000)	<b>-0.500**</b> (0.000)											
Dir%Own	-0.114 (0.180)	<b>-0.204*</b> (0.016)	0.010 (0.909)	0.026 (0.759)	-0.041 (0.631)										
SplitRole	0.036 (0.672)	<b>0.337**</b> (0.000)	<b>0.168*</b> (0.048)	<b>0.229**</b> (0.006)	-0.068 (0.425)	0.010 (0.905)									
DualList	0.006 (0.941)	0.112 (0.187)	<b>0.166*</b> (0.049)	<b>0.188*</b> (0.026)	0.024 (0.776)	0.033 (0.696)	<b>0.242**</b> (0.004)								
DivPay	<b>0.155</b> (0.068)	-0.014 (0.869)	-0.019 (0.827)	0.102 (0.231)	-0.066 (0.442)	-0.011 (0.901)	-0.035 (0.681)	-0.018 (0.832)							
ROE	<b>0.241**</b> (0.004)	<b>0.237**</b> (0.005)	<b>0.178*</b> (0.035)	-0.006 (0.942)	0.130 (0.127)	-0.092 (0.279)	-0.003 (0.972)	0.035 (0.680)	<b>-0.218*</b> (0.010)						
LnSales	-0.006 (0.947)	0.110 (0.195)	-0.073 (0.392)	0.029 (0.730)	-0.079 (0.357)	<b>-0.197*</b> (0.020)	0.039 (0.649)	<b>0.203*</b> (0.016)	-0.025 (0.771)	<b>0.159</b> (0.061)					
SalGrow	0.050 (0.560)	0.091 (0.284)	0.030 (0.722)	-0.112 (0.186)	0.098 (0.250)	-0.029 (0.732)	0.003 (0.971)	<b>-0.158</b> (0.062)	<b>-0.200*</b> (0.018)	0.108 (0.204)	-0.086 (0.311)				
LnTA	<b>-0.505**</b> (0.000)	0.065 (0.448)	-0.027 (0.751)	<b>0.243**</b> (0.004)	<b>-0.203*</b> (0.016)	0.077 (0.364)	-0.031 (0.713)	0.037 (0.663)	<b>-0.396**</b> (0.000)	-0.015 (0.856)	<b>0.171*</b> (0.043)	0.002 (0.980)			
LnEqty	<b>-0.462**</b> (0.000)	0.051 (0.550)	-0.030 (0.728)	<b>0.241**</b> (0.004)	<b>-0.192*</b> (0.023)	0.074 (0.387)	-0.028 (0.738)	0.071 (0.405)	<b>-0.309**</b> (0.000)	-0.086 (0.313)	<b>0.225**</b> (0.007)	-0.048 (0.570)	<b>0.950**</b> (0.000)		
Debt/TA	<b>-0.313**</b> (0.000)	0.044 (0.608)	0.003 (0.974)	0.131 (0.122)	-0.138 (0.103)	0.050 (0.558)	-0.015 (0.865)	-0.090 (0.288)	<b>-0.390**</b> (0.000)	<b>0.179*</b> (0.034)	-0.078 (0.361)	0.077 (0.363)	<b>0.526**</b> (0.000)	<b>0.249**</b> (0.003)	
PTBV	<b>0.785**</b> (0.000)	<b>0.318**</b> (0.000)	0.001 (0.993)	-0.069 (0.415)	0.062 (0.467)	-0.206 (0.014)	0.003 (0.975)	0.052 (0.546)	0.051 (0.552)	<b>0.367**</b> (0.000)	<b>0.230**</b> (0.006)	0.040 (0.638)	<b>-0.425**</b> (0.000)	<b>-0.415**</b> (0.000)	<b>-0.227**</b> (0.007)

(*p*-values are shown in brackets. Coefficients are **bold** if *p*-value < 0.10; \* if *p*-value < 0.05; \*\* if *p*-value < 0.01. PTBV denotes Price-to-Book Value of Equity of firms)

## 9.5 Differences amongst LargeCap, MidCap, and SmallCap firms

The Pearson correlation test on the variables in Section 9.4 has identified that CGDscore is significantly correlated to market valuation  $q$  for SmallCap firms (Table 9.9 refers), but not necessary so for LargeCap or MidCap firms (as shown in Tables 9.3 and 9.6 respectively). CGDscore, however, is generally associated with some other corporate governance practices (CGpractices) variables such as board size, insiders' ownership, the percentage of INEDs on the board, and split roles of the Chairman and CEO. Analytical tests, using multiple regression models as stated in Chapter 8, will be able to assess the impact of each explanatory variable (e.g., those CGpractices variables) on the dependent variable (e.g., market valuation  $q$ ). Before such a relational test is carried out, it would be necessary to evaluate if the key variables would change substantially over the years of study for LargeCap, MidCap, and SmallCap firms.

### 9.5.1 Differences in the key corporate governance variables for 2003 – 2005

Four key variables related to a firm's corporate governance are identified and tested to determine if there are any significant changes over time of the study period. They are: CG disclosure score (CGDscore),  $q$ , Dividend Payout, and Director Ownership, which are the core variables of interest in this study as discussed in Section 9.2 of this Chapter. Understanding the changes in these variables, if there are any, may shed light on the interpretation of the results of the subsequent regression analyses. To test for the differences of variables over the years, a  $t$ -test of the difference between two population means is conducted for years 2004 over 2003, 2005 over 2004, and 2005 over 2003 for each category of LargeCap firms, MidCap firms, and SmallCap firms.

The results of the  $t$ -test are presented in Table 9.10 with comments as follows:



**Table 9.10 *t*-statistics of CG scores, *q*, Dividend Payout, and Directors'Ownership in 2003-2005 for all firms: comparison by year**

Variables	Market Capitalization	<i>t</i> -statistics ( <i>p</i> -value)		
		2004/2003	2005/2004	2005/2003
CGDscore	LargeCap	<b>2.38*</b> (0.014)	<b>1.92*</b> (0.035)	<b>5.41**</b> (0.000)
	MidCap	<b>2.34*</b> (0.012)	<b>3.16**</b> (0.001)	<b>6.14**</b> (0.000)
	SmallCap	<b>3.66**</b> (0.0001)	<b>6.13**</b> (0.0001)	<b>10.64**</b> (0.0001)
<i>q</i>	LargeCap	0.03 (0.487)	0.07 (0.471)	0.11 (0.457)
	MidCap	-0.02 (0.494)	0.63 (0.267)	0.59 (0.278)
	SmallCap	<b>1.84*</b> (0.034)	-0.67 (0.252)	<b>1.39</b> (0.085)
DivPay	LargeCap	-1.18 (0.126)	<b>-1.33</b> (0.100)	<b>-2.91**</b> (0.004)
	MidCap	<b>-1.51</b> (0.068)	<b>-1.44</b> (0.078)	<b>-2.87**</b> (0.003)
	SmallCap	-0.57 (0.284)	-0.96 (0.169)	<b>-1.39</b> (0.084)
Dir%Own	LargeCap	-0.02 (0.494)	0.15 (0.442)	0.13 (0.449)
	MidCap	-0.02 (0.492)	-0.20 (0.420)	-0.22 (0.412)
	SmallCap	-0.44 (0.330)	-0.49 (0.312)	-0.91 (0.181)

(Notes:

*p*-values are shown in brackets. *P*-values are bold if < 0.1; \* if < 0.05; and \*\* if < 0.01)

The results indicate the following findings:

- (i) CGDscores are significantly different (at 0.05 level) for each pair-comparison for all three years for LargeCap firms, MidCap firms and SmallCap firms. As discussed earlier in the respective sections in this Chapter, firms have paid increasing attention to corporate governance, with more disclosure on their corporate governance year on year (as shown in the positive values of the *t*-statistics in Table 9.10, rows 3-5, columns 3-5). All three classes of market capitalization of the sample firms have shown an increase in their CG disclosure, and this increase is statistically significant (*p*-value < 0.05). Therefore, it may be postulated that some rationale may be underlying these significant changes in the yearly CG disclosure scores for all categories of firms in 2003, 2004, and 2005.

- (ii) The market valuation proxy,  $q$ , is significantly different in 2004 from 2003 for SmallCap firms (Table 9.10, row 8, column 3). It is also different, only marginally, in 2005 when compared to 2003 (Table 9.10, row 8, column 5). From Table 9.7 in the previous section, it is already noted that  $q$  rises from 1.21 to 1.59 in 2003/2004 for SmallCap firms. This change in  $q$  can be affirmed by the  $t$ -statistics in Table 9.10 to be statistically significant, with  $p$ -value equals 0.034 (Table 9.10, row 8, column 3).

Correspondingly, there is a highly significant change ( $p$ -value  $< 0.0001$ ) observed in the CGDscores for SmallCap firms (Table 9.10, row 5, column 3). Likewise, the changes in CGDscore for both LargeCap firms and MidCap firms from 2003 to 2004 are statistically significant, with  $p$ -values smaller than 0.05 (Table 9.10, rows 3 and 4), but they are not accompanied by any corresponding changes in  $q$ . If CG disclosure has value relevance to a firm, then it seems that it is only manifested in SmallCap firms and not in the other two categories of sampled firms. In fact, no statistically significant changes in  $q$  are observed for either LargeCap or MidCap firms for other periods. Hence, the value relevance of CG disclosure seems to be more pronounced in SmallCap firms than in LargeCap or MidCap firms. Previous literature has not found any *prima facie* evidence to support the assertion that changes of sample firms' CGDscores are universally related to the changes of  $q$  for *all* types of sample firms. The results of Table 9.10 (row 5 and row 8) suggest that SmallCap firms may be a bit different from the others.

- (iii) In terms of Dividend Payout, the decrease in payout ratio for LargeCap firms in 2004/2003 (Table 9.10, row 9, column 3) is statistically non-significant ( $p$ -value = 0.126) whereas the decrease in 2005/2004 is fairly significant ( $p$ -value = 0.100, Table 9.10, row 9, column 4). DivPay for LargeCap firms in 2005 is significantly less than that in 2003 ( $p$ -value = 0.004), as shown in Table 9.10, row 9, column 5.

Similarly, the dividend payout ratio for MidCap firms in 2005 is less than that in 2003, which is highly significant ( $p$ -value = 0.003, as shown in table 9.10, row 10, column 5). Compared with 2003, MidCap firms pay less in 2004, which is statistically fairly significant ( $p$ -value = 0.068, as shown in Table 9.10, row 10, column 3). The decline in DivPay for Midcap firms for 2005/2004 is also fairly significant ( $p$ -value = 0.078,

as shown in table 9.10, row 10, column 4). Among three categories of firms, MidCap firms' decreases in DivPay over the years were statistically significant, suggesting that there is no historical pattern in their dividend policies.

SmallCap firms also display a declining trend in Dividend Payout, but the differences in dividend payout ratios across all three years do not show any changes that are statistically significant. It may be true that SmallCap firms are paying less dividend ratios year on year, but the differences are not statistically significant from one year to another. Among the three categories of firms, SmallCap firms seem to be the only one that exhibits a steady pattern of dividend policy.

- (iv) There are some differences in respect of Director Ownership for LargeCap, MidCap, and SmallCap firms across the years (Table 9.10, rows 12-14). However, such differences are not statistically significant. It suggests that for the sample firms, insider ownership tends to be similar over the years, regardless a firm's capitalization.

In conclusion, both LargeCap and MidCap firms show significant decreases in their Dividend Payout for in 2005 compared to 2003, but no significant changes for SmallCap firms are noted. In addition, the market valuation proxy,  $q$ , of LargeCap and MidCap firms show no significant changes over the three years of study, but the  $q$  of SmallCap firms in 2004/2003 is significantly different and that the  $q$  in 2005/2003 is also fairly different. All in all, the statistics suggest that there are more similarities between LargeCap and MidCap firms than between MidCap and SmallCap firms in terms of the pattern of changes in the four variables: CGDscore,  $q$ , Dividend Payout, and Director Ownership.

The  $t$ -statistics and the  $p$ -values in Table 9.10 above also show that changes in the four key variables (i.e., CG Score,  $q$ , Dividend Payout, and Dir%Own) for LargeCap firms are quite similar to the changes for MidCap firms over the entire period of study 2003-2005. Due to their resemblances in respect of these four key variables, a possibility is opened up to pool LargeCap firms (L) with MidCap firms sample (M) into a larger sample (L+M), ready for further regression analyses. A larger sample size yields more reliable statistics to be estimated on the same regression model, without causing any alterations to the fundamental nature of those four variables of corporate governance. In the next section, analysis will be

made to test if there are systematic differences across the three samples of firms (L, M, and S) in respect of the four key variables in this study, on a per-year basis.

### 9.5.2 Hypotheses for testing the differences in key corporate governance variables amongst categories of firms by year

In section 9.5.1, *t*-tests are conducted based on the *ex ante* classification criterion – the market capitalisation of the firms – as prescribed by the Hang Seng Hong Kong Composite Index. In this section, a *t*-test is conducted to find out if there are any differences amongst the different categories of firms in terms of the four key variables of corporate governance, on a year-by-year basis. To recap, the four variables are: (i) corporate governance disclosure (CGDscore); (ii) market valuation as proxied by *q*, (iii) dividend payout ratio (DivPay); and (iv) directors' ownership (Dir%Own).

A family of null hypothesis is to be tested as follows:

$$H_0: X_{iL} = X_{iM} = X_{iS} \text{ for year } t$$

where:

$X_i$  = mean of variable *i* (*i* = 1,2,3,4);

$X_1$  = mean of CGDscore;

$X_2$  = mean of *q*;

$X_3$  = mean of Dividend Payout;

$X_4$  = mean of Dir%Own.

*L* = LargeCap firms;

*M* = MidCap firms;

*S* = SmallCap firms;

*t* = 2003, 2004, and 2005.

Specifically, four null hypotheses can be stated as follows:

- 1) There is no statistically significant difference in the CG disclosure among LargeCap, MidCap, and SmallCap firms for each year in 2003-2005. In functional form, this hypothesis is expressed as:

$$H_1: \text{CGDscore}_L = \text{CGDscore}_M = \text{CGDscore}_S$$

- 2) There is no statistically significant difference in market valuation *q* among LargeCap, MidCap, and SmallCap firms for each year in 2003-2005, expressed as:

$$H_2: q_L = q_M = q_S$$

- 3) There is no statistically significant difference in dividend payout ratio among LargeCap, MidCap, and SmallCap firms for each year in 2003-2005, expressed as:

$$H_3: \text{DivPay}_L = \text{DivPay}_M = \text{DivPay}_S$$

- 4) There is no statistically significant difference in insider (director) ownership among LargeCap, MidCap, and SmallCap firms for each year in 2003-2005, expressed as:

$$H_4: \text{Dir\%Own}_L = \text{Dir\%Own}_M = \text{Dir\%Own}_S$$

The results of the  $t$ -tests for 2003, 2004, and 2005 can test whether the above-mentioned four hypotheses can be accepted or rejected. The test results are presented in the next section.

### **9.5.3. Differences between pairs of categories of firms by year**

The objectives of the  $t$ -tests conducted between LargeCap and MidCap firms, MidCap and SmallCap firms, and LargeCap and SmallCap firms on a yearly basis are to investigate whether these firms, with ex-ante different market capitalizations, would differ from each other year by year in terms of the four key variables as mentioned in Section 9.5.2. If no yearly difference is observed, then it can be interpreted that these key variables remain relatively unchanged over the years for all types of firms. The  $t$ -statistics and their  $p$ -values (stated in brackets) of the 4 major variables for each year from 2003 to 2005 are shown in Table 9.11.

**Table 9.11 *t*-statistics of CGD scores, *q*, Dividend Payout, and Director's Ownership in 2003-2005 for all firms: comparison by firms' capitalisation**

Variables	Year	<i>t</i> -statistics ( <i>p</i> -value)		
		LargeCap vs. MidCap	MidCap vs. SmallCap	LargeCap vs. SmallCap
CGDscore	2003	-0.81 (0.212)	<b>1.55</b> (0.066)	0.29 (0.388)
	2004	-0.190 (0.4298)	<b>1.49</b> (0.072)	1.11 (0.142)
	2005	<b>-1.64</b> (0.055)	0.86 (0.196)	-1.03 (0.155)
<i>q</i>	2003	-1.299 (0.101)	<b>2.03*</b> (0.025)	0.68 (0.251)
	2004	-1.27 (0.105)	0.82 (0.207)	-0.68 (0.250)
	2005	<b>-1.82*</b> (0.039)	<b>2.00*</b> (0.027)	-0.13 (0.450)
DivPay	2003	-0.26 (0.397)	<b>2.16*</b> (0.018)	<b>2.06*</b> (0.023)
	2004	0.09 (0.464)	1.29 (0.101)	1.29 (0.105)
	2005	0.29 (0.385)	0.46 (0.324)	0.87 (0.193)
Dir%Own	2003	-1.17 (0.128)	-0.03 (0.489)	-1.26 (0.112)
	2004	-1.19 (0.126)	0.33 (0.371)	-1.02 (0.162)
	2005	-0.86 (0.200)	0.53 (0.298)	-0.49 (0.314)

(Notes: *p*-values are shown in brackets. *P*-values are bold if < 0.1; \* if < 0.05; and \*\* if < 0.01)

The following observations are made on a yearly basis with reference to Table 9.11:

(i) Year 2003

When MidCap firms are compared to SmallCap firms (column 4, rows 3, 6, and 9), MidCap firms show a statistically significant difference from SmallCap firms in three out of four key variables: CGDscore (fairly significant, *p*-value = 0.066), *q* (significant, *p*-value = 0.025), and DivPay (significant, *p*-value = 0.018). Comparing LargeCap firms with SmallCap firms in the same year, only in one variable, DivPay, is a significant difference detected (*p*-value = 0.023, as shown in row 9, column 5). No significant differences are found in terms of Director Ownership for all three pair-comparisons of firms. Therefore, the test results for 2003 (Table 9.11, rows 3, 6, 9, and 12) show that the null hypotheses:

$H_1$ :  $CGDscore_L = CGDscore_M = CGDscore_S$  is rejected.

$H_2$ :  $q_L = q_M = q_S$  is rejected.

$H_3$ :  $\text{DivPay}_L = \text{DivPay}_M = \text{DivPay}_S$  is rejected.

$H_4$ :  $\text{Dir\%Own}_L = \text{Dir\%Own}_M = \text{Dir\%Own}_S$  cannot be rejected.

(ii) Year 2004

Except for CGDscore where MidCap firms are significantly different from SmallCap firms statistically, all pair comparisons of firms exhibit very similar patterns to each other (Table 9.11, rows 4, 7, 10, and 13). The test results for 2004 show that the null hypotheses:

$H_1$ :  $\text{CGDscore}_L = \text{CGDscore}_M = \text{CGDscore}_S$  is rejected.

$H_2$ :  $q_L = q_M = q_S$  cannot be rejected.

$H_3$ :  $\text{DivPay}_L = \text{DivPay}_M = \text{DivPay}_S$  cannot be rejected

$H_4$ :  $\text{Dir\%Own}_L = \text{Dir\%Own}_M = \text{Dir\%Own}_S$  cannot be rejected.

(iii) Year 2005

LargeCap firms tend to differ statistically and significantly from MidCap firms in terms of CGDscore and  $q$ . In terms of  $q$ , there is statistically significant difference between MidCap firms and SmallCap firms too. LargeCap firms are not significantly different from SmallCap firms for all four variables (Table 9.11, rows 5, 8, 11, and 14). The test results in 2005 show that the null hypotheses:

$H_1$ :  $\text{CGDscore}_L = \text{CGDscore}_M = \text{CGDscore}_S$  is rejected.

$H_2$ :  $q_L = q_M = q_S$  is rejected.

$H_3$ :  $\text{DivPay}_L = \text{DivPay}_M = \text{DivPay}_S$  cannot be rejected

$H_4$ :  $\text{Dir\%Own}_L = \text{Dir\%Own}_M = \text{Dir\%Own}_S$  cannot be rejected.

The  $t$ -test results in 2005 also show that in terms of CGDscore, LargeCap tend to disclose statistically less than MidCap firms, which is statistically fairly significant ( $p$ -value = 0.055, as shown in row 5, column 3). In contrast, MidCap and SmallCap firms are quite similar, and so are LargeCap firms and SmallCap firms. It indicates that, in 2005 which is the year for complying with the new regulations, MidCap firms disclosed their CG practices the most, followed by SmallCap firms, and lastly by LargeCap firms.

To sum up, the  $t$ -test results by year indicate that, in 2003, all three categories of firms have no differences that are statistically significant in terms of Director's Ownership, but they differ in terms of CGDscore,  $q$  and Dividend Payout. In 2004, these firms became similar in terms of  $q$ , Dividend Payout, and Director Ownership. They remained different in terms of

CGDscore. In 2005, the firms are moderately different in respect of CGDscore, but show a highly significant difference in terms of  $q$ . They were similar to each other in terms of Dividend Payout and Director Ownership. It is noted that throughout the study period, the Director Ownership of three categories of firms did not differ significantly, which is consistent with previous literature that shows firms in Hong Kong are characterized with predominant ownership that seldom changes over years. Predominant ownership by insiders seems to be pervasive and persistent amongst Hong Kong firms.

#### **9.5.4. Differences in key corporate governance variables by market capitalization**

The results in Table 9.11 (column 4) can also indicate if firms of various market capitalizations would differ in terms of the four key variables. For instance, from column 4, it can be shown that MidCap firms are different from SmallCap firms in three aspects: i.e., CG Disclosure Score (moderately different in 2003 & 2004);  $q$  (significantly different in 2003 and 2005); and Dividend Payout (significantly different in 2003). In contrast, Table 9.11 (column 5) shows that LargeCap firms differ significantly from SmallCap firms on Dividend Payout in 2003 only (column 5, row 9). These incidents of differences imply that MidCap firms are closer to LargeCap firms than to SmallCap firms. Apart from the differences mentioned above, their CG characteristics have been quite similar to one another, particularly, in respect of Director Ownership for the period of study.

One of the objectives of this study is to find out the effect of voluntary disclosure of CG practices on the market valuation of a firm, for firms of different categories of market capitalization. This study differs from previous studies, which often pooled various firms of various market capitalizations together as samples. It is for this reason that firms of the Hang Seng Hong Kong Composite Index (HSKCI) that categorizes firms by market capitalization are used in this study. To carry out further empirical tests to meet the objective stated above, regression analyses are to be conducted. However, it has been known that sample size is a factor that affects the reliability of the outcome of the regression analysis. If sample size is too small, the result of the regression analysis is unlikely to be reliable. In this study, the number of firm-years is 36 for LargeCap firms, 84 for MidCap firms, and 140 for SmallCap firms. The small sample size of LargeCap firms may be a concern for getting reliable results from the regression analysis.



A possible way to overcome the sample size problem is to merge LargeCap firms with MidCap firms into one sample (i.e., L+M sample), as they are close to each other in terms of market capitalization, Dividend Payout, and Director Ownership. The *t*-test results reported in Table 9.11 above show that MidCap and LargeCap firms are more similar to each other than is the case of combining MidCap with SmallCap firms. The enlarged L+M sample should be a viable research design strategy to overcome the small sample size problem for LargeCap firms, because it will enhance the explanatory power of the regression models.

On the other hand, one may argue that, as the *t*-test results also show that LargeCap firms are similar to SmallCap firms (in that LargeCap firms and SmallCap firms only differ significantly in terms of Dividend Payout in 2003), it should also be viable to merge LargeCap firms with SmallCap firms (i.e., L+S sample). However, there is a big difference between LargeCap firms and SmallCap firms in terms of market capitalization and proportion of dual listing, as explained in the previous Chapters. When a regression model is applied onto a combined L+S sample composed of LargeCap firms and SmallCap firms, the model may average out their differences and yield an analytical result not much different from the pooled samples, i.e., a mixture of firms of different market capitalisations, as had been used in prior studies. As the L+S sample cannot serve the purpose of this study and is likely to be repetitive of previous researchers' work, it is not adopted in this study.

## 9.6 Summary

This chapter presents the descriptive statistics and the results of the univariate analyses of the variables for the sample firms in relation to four key aspects, namely, market valuation as proxied by Tobin's *q*; CG disclosure scores (CGDscore); directors' ownership of the firm (Dir%Own); and dividend payout ratio (DivPay) in respect of the constituent stocks of the HSHKCI index for LargeCap, MidCap, and SmallCap firms.

In terms of the market valuation *q*, it is found that the pattern of changes during the study period is different for different categories of firms. The change in *q* for LargeCap firms is minimal, while the change in *q* for SmallCap firms is volatile. Evidence also suggests that the market valuation of a firm does not correspond directly to its market capitalization, as the

average  $q$  for MidCap firms ( $q = 1.95$ , as per Table 9.5) is found to be higher than that of LargeCap firms ( $q = 1.4$ , as per Table 9.2).

There is a general increase in the CG disclosure for all categories of firms during the period of study, which may be an outcome of the efforts by the Hong Kong Stock Exchange in introducing the Recommended Best Practice and code provision on CG for the listed firms. A substantial increase in CG disclosure is noticed in 2005 for MidCap firms and SmallCap firms.

In contrast, the directors' ownership of a firm's equity is found to be high across all categories of firms, but it does not change drastically over the three years. Half of the MidCap firms, as well as half of the SmallCap firms, in the sample of this study have 54% or more directors' ownership of equity (i.e., a predominant insiders' ownership, as per Table 9.5 and Table 9.8, respectively). As for the LargeCap firms, the median Dir%Own is 49% (Table 9.2), which is considered as high when compared to other diffusely owned firms in the U.S. and U.K., as reported in previous research. A high level of insiders' ownership implies that decisions by managers can be promptly approved by insider owners who are more informed than outside investors. Hence, it is likely that firms with high insiders' ownership may exhibit a different pattern of voluntary CG disclosure than firms with a diffuse ownership. Subsequently, the impact of voluntary CG disclosure on a firm's valuation may differ.

In terms of dividend payout, the descriptive statistics of this study indicate that SmallCap firms offer the lowest DivPay (42.47%, Table 9.8), as compared to LargeCap firms and MidCap firms (about 51%, Table 9.2 and Table 9.5). The evidence shows that, in a strong legal investor protection environment such as Hong Kong, minority shareholders of SmallCap firms are receiving dividends not as much as other shareholders of LargeCap or MidCap firms. A possible interpretation of this evidence is that the outside investors of a SmallCap firm have not opted to exercise their legal rights to demand a high payout (as suggested in LLSV's (2000b) dividends outcome model); or that they have been unable to do so due to the predominant ownership by insiders (i.e., manager-owners of the firms). If the latter interpretation is the case, it is expected that outside investors may not be willing to pay a premium price for the shares of the SmallCap firm. As such, the market valuation of the firm will be expected to be adversely affected.

Regarding the univariate analyses, the results of the Pearson correlations show that CG disclosure is positively and significantly related to the number, and the percentage, of the INEDs on the board (at 0.1 alpha level). The finding is consistent with the view that the INEDs could help alleviating the information asymmetry between insiders and outsiders of a firm. On the other hand, CG disclosure is negatively correlated with directors' equity ownership of a firm. This is consistent with the notion that, among tightly-owned firms, information about a firm's CG is less likely to be shared with or disclosed to outsiders.

Results of the correlation test between  $q$  and various CG practices variables suggest that the association of  $q$  with individual CG practices may differ with firms. For LargeCap firms, a significant and positive relationship is found between  $q$  and Board Size; but a negative relationship is present between  $q$ , the number of INEDs, and the dual listing status of the firm. For MidCap firms, a significant and positive relationship is found between  $q$  and the percentage of INEDs, and the split role of Chairman and CEO. For SmallCap firms,  $q$  is significantly and positively correlated with CGDscore (at 0.10 alpha level) and DivPay. On the other hand, significant relationships between  $q$  and some control variables (such as Return on Equity and Total Assets) are found to exist for LargeCap firms and MidCap firm, but not for SmallCap firms.

Similarly, the impact on DivPay by the CG practices variables vary with the market capitalization of the firms. For LargeCap firms, their DivPay is significantly correlated with the dual listing status (positively) and the number of INEDs (negatively). For MidCap firms, the DivPay is significantly associated with the number of INEDs (positively) and the Split Role of Chairman and CEO (positively). The evidence suggests that a higher level of dividend payout can be associated with better corporate governance practices for the MidCap firms. However, no similar association between DivPay and CG variables is found for SmallCap firms, which further adds to the argument that the presence of a predominant insider ownership may be a factor that the minority outside investors are not receiving as much dividends as those investors who have stakes in MidCap or LargeCap firms.

Finally, the results of correlation tests for Director Ownership (Dir%Own) for the three categories of firms are found to be mixed. For MidCap firms, Director Ownership is negatively (at 0.05 alpha level) correlated with CG practices variables such as the number of INEDs, the percentage of INEDs on the board, and dual listing status, all negatively. This

implies that more corporate governance practices are installed where insider ownership is low. However, such relationship is not found for LargeCap and SmallCap firms.

In conclusion, the correlation results shown above show that the relationships between each of the four key variables in this study (CGDscore,  $q$ , Dir%Own, and DivPay) and other explanatory variables defined in this study have not been consistent for all three categories of firms. The differences in correlations may be induced by the characteristics specific to each category of firms inherent in their market capitalization (as pre-determined by the HSHKCI index), or attributed to firm-specific characteristics that are not related to market capitalization. In view of the different characteristics of the firms, the sample firms will be partitioned into three different groupings and tested with multiple regression analyses: (i) the pooled sample comprising all firms in the LargeCap, MidCap and SmallCap firms (as commonly used by prior studies); (ii) the combined sample of LargeCap and MidCap firms; and (iii) the sample of SmallCap firms only.

Multivariate analyses are conducted to explore the impact of CG practices variables, company characteristics variables, and directors' ownership on the key areas of market valuation of a firm ( $q$ ), CG disclosure, and dividend payout, with respect to the research questions of this study as set out in Chapter 6. The test results of the multivariate analyses on the models for these three partitioned samples will be presented in the next chapter, Chapter 10.

# Chapter 10: Empirical Test Results

## 10.1 Introduction

This chapter presents the empirical test results of the models as discussed in Chapter 8, which are constructed to test five key hypotheses and their subsidiary hypotheses previously set out in Chapter 6. Each key hypothesis is to be tested by a key model, and the subsidiary hypotheses are tested by the extended models. As discussed in Chapter 8, these models are used to test the relationship between three key dependent variables, namely,  $q$  (representing the market value of a firm); CGDscore (representing the state of CG disclosure of a firm); and DivPay (representing the level of dividend payout made by a firm to its shareholders); and the explanatory variables relating to the corporate governance practices of a firm whilst controlling for a firm's performance, capital structure, and ownership.

The structure of this chapter is as follows. Section 10.2 presents the results for Model 1.0, which tests the effect of CGDscore on a firm's market valuation  $q$ . Section 10.3 reports the results for the extended model (Model 1.1), which tests the same relational effect of CGDscore on  $q$  as in Model 1.0, but with five additional CG practices variables included as explanatory variables. Section 10.4 provides the results of a further extended model (Model 1.2), which incorporates some variables related to the company's characteristics in the relational test. Section 10.5 discusses the results of Model 1.3, which extends Model 1.2 by including the joint variable of CG-Rank-Director-Ownership as explanatory variable in the model.

Section 10.6 presents the empirical test results for Model 2.0, which tests the relationship between voluntary CG disclosure and the CG practices and company characteristics for sample firms. Section 10.7 reports the test results for Model 3.0, testing whether a systematic difference in the level of CG disclosure among firms is present in the three categories of sampled firms.

Section 10.8 reports the results for Models 4.0 and 4.1, which test the relationship between Dividend Payout and other explanatory variables such as the CGDscore, CG practices variables, and company characteristics, as stated in Hypothesis 4.

In section 10.9, Model 4.0 is extended to Model 4.1 to test the extent to which a firm's dividend payout is affected by the joint variable of CG Rank-Director Ownership. The results of these extended models shall provide answers to Hypothesis 5, which postulates that firms with a medium level of insider ownership tends to exhibit the lowest dividend payout ratio.

Section 10.10 provides some robustness tests on some key models, while Section 10.11 concludes the chapter with a summary.

As discussed in Chapter 9, the SmallCap firms tend to be different from LargeCap and MidCap firms in terms of some key variables such as CGDscore,  $q$ , and Dividend Payout. Therefore, it seems justifiable to partition the sample firms into three sub-samples, and test the models on them accordingly. These sub-samples are, namely, the pooled sample of LargeCap, MidCap, and SmallCap firms (the L+M+S sample), the combined sample of LargeCap and MidCap firms (the L+M sample), and the sample of SmallCap firms (the S sample).

The empirical test results for the various models are presented in this chapter. For ease of comparison, the regression results for the models applied onto all three sub-samples are displayed side by side in the same table.

## 10.2 Testing the effect of CGDscore on firm valuation

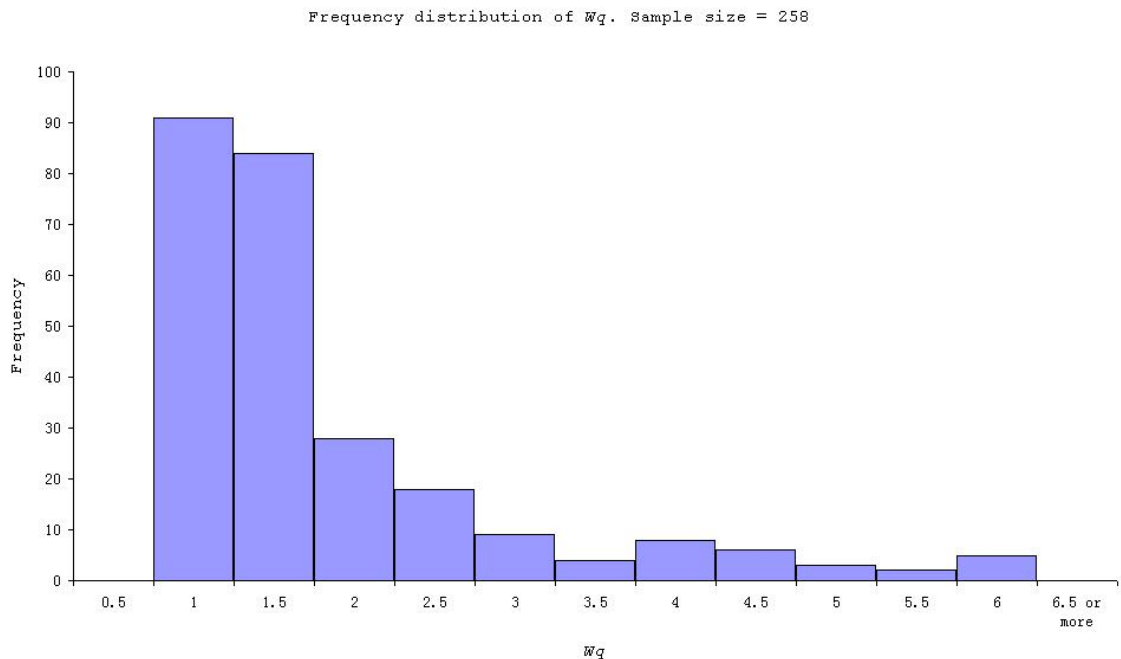
This section reports the findings of Model 1.0, which is constructed to test Hypothesis H1 as stated earlier in Chapter 6. Before the findings are presented, some discussion on the treatment of the dependent variable,  $q$ , is provided.

### 10.2.1 Winsorization of the dependent variable $q$

Before Model 1.0 is applied to the partitioned samples, a review of the descriptive statistics in Chapter 9 shows that  $q$ , which proxies for market valuation of a firm, has a wide spread from 0.34 (in 2003 for SmallCap firms) to 6.85 (in 2005 for MidCap firms), as shown in Table 9.7 (Panel B) and Table 9.5 (Panel B) respectively. These extreme values in  $q$ , which are more than three standard deviations away from their mean, are likely to bias the estimates of the coefficients in the regression models. To reduce the impact of extreme values on the regression results, the  $q$ 's are winsorized at 5% and 95%, i.e., setting the lower 5% and uppermost 5% percentiles equal to values at the 5<sup>th</sup> and 95<sup>th</sup> percentiles

respectively.<sup>1</sup> The frequency distribution of winsorized  $q$  ( $Wq$ ) for the pooled sample is shown in Figure 10.1. After winsorization,  $Wq$  tends to fall mostly between 1.0 and 1.5 (Figure 10.1). All  $q$ 's in the three partitioned samples have been individually winsorized at 5% and 95%. Henceforth,  $Wq$  will replace  $q$  for testing the models in this study, unless specified otherwise.

**Figure 10.1** Frequency distribution of  $Wq$ . Sample size = 258.



### 10.2.2 Testing the impact of various firms' CGDscore on valuation

The first main hypothesis in this study, Hypothesis 1 ( $H1$ ), postulates that firms with more voluntary disclosure tend to have higher market valuation. From Chapter 8, it is re-stated as follows:

*H1: Firms that voluntarily disclose more information with regards to their corporate governance practices have higher market valuation than firms that disclose less, ceteris paribus.*

As discussed in Chapter 8, this key hypothesis can be expressed in terms of three sub-hypotheses ***H1a***, ***H1b***, and ***H1c***; which are to be tested separately by different extended models. Sub-hypothesis ***H1a*** is re-stated from Chapter 8 as follows:

***H1a:*** A firm's market valuation as proxied by  $Wq$  is a function of its CG disclosure.

<sup>1</sup> Winsorizing the extreme values of a variable before conducting a regression model is commonly practised in accounting research studies (e.g. Fan and Wong, 2005; Lang, Lins and Miller, 2004).

Model 1.0 explores the relationship between a firm's valuation represented by  $Wq$  and the CG disclosure score (CGDscore) of the firm given by a simple regression:

$$Wq_{i,t} = \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \varepsilon_{i,t} \dots \dots \dots (\text{Model 1.0})$$

where  $Wq$  is the winsorized  $q$ ,  $\beta_0$  the intercept,  $\beta_1$  the coefficient for CGDscore, and  $\varepsilon$  is the error term with  $i = 1, 2, 3 \dots, n$ th firm and  $t$  runs for year 2003, 2004, and 2005. CGDscore is the score of a firm's CG disclosure as defined in Chapter 7.

The simple regression model is firstly applied to separate market capitalization of firms individually. LargeCap (L) firms are tested in Model 1.0\_L, MidCap (M) firms are tested in Model 1.0\_M, and SmallCap (S) firms are tested in Model 1.0\_S. Then the firms are partitioned into two groups to form a bigger sample size for testing the simple regression model. The findings based on the windsorised  $q$  ( $Wq$ ) are presented in Table 10.1 below.

**Table 10.1 Results of market valuation regressed on CGDscore. Dependent variable =  $Wq$ .**

	1	2	3	4	5	6
1	Model	1.0_L	1.0_M	1.0_S	1.0_LMS	1.0_LM
2	Sample	L	M	S	L+M+S	L+M
3	Observations	36	82	140	258	118
4	Intercept	<b>1.587**</b> (0.0001)	<b>1.808**</b> (0.0001)	<b>1.181**</b> (0.0001)	<b>1.376**</b> (0.0001)	<b>1.675**</b> (0.0001)
5	CGDscore	-0.005 (0.528)	0.003 (0.699)	<b>0.007</b> (0.072)	0.005 (0.108)	0.002 (0.666)
6	Adj. $R^2$	-0.017	-0.011	0.016	0.010	0.002
7	Significance F	0.528	0.699	<b>0.072</b>	0.108	0.666

(Notes:  $P$ -values are shown in brackets. Coefficients are bold if  $p$ -values < 0.10; \* if  $p$ -values < 0.05; and \*\* if  $p$ -values < 0.01)

For the individual samples, the coefficient on CGDscore is not statistically significant for LargeCap firms (Table 10.1, row 5, column 2) and MidCap firms (row 5, column 3) at any significance level, but it is statistically significant at 0.10 level for SmallCap firms (row 5, column 4). The disclosure of CG information is found to have a positive and significant impact on SmallCap firms.

For the pooled sample of LargeCap, MidCap, and SmallCap firms (henceforth referred to as the L+M+S sample, as shown in Table 10.1, row 2, column 5), Model 1.0\_LMS (Table 10.1, column 5) indicates that both the coefficient for the CGDscore and the adjusted  $R^2$



are very small (0.005 and less than 0.01, respectively). However, the  $p$ -value for the CGDscore is 0.108 (Table 10.1, row 5, column 5), marginally insignificant at the 0.10 level. In contrast, the intercepts shows a coefficient of 1.376 (row 4, column 5), which are highly significant at 0.01 level. An intercept with such a significant level indicates that some omitted variables may be absent from the regression models. Hence, the results indicate that CGDscore by itself has very limited explanatory power to account for the market valuation  $Wq$  of the firms in the L+M+S sample.

For the combined sample of LargeCap and MidCap firms (henceforth referred to as the L+M sample), Model 1.0\_LM (Table 10.1, column 6) shows that the coefficient for the CGDscore is 0.002 and is not statistically significant (Table 10.1, row 5, column 6). The empirical results are similar to those for Model 1.0\_LMS on the L+M+S sample.

In contrast, for the sample of SmallCap firms (henceforth referred to as the S sample), Model 1.0\_S (Table 10.1, column 4) shows that the coefficient for CGDscore is 0.007, which is statistically significant at 0.05 alpha level (row 5, column 4). Comparing Model 1.0\_S with other models in Table 10.2, the coefficient on the CGDscore for the SmallCap firms in the S sample is much higher, and statistically more significant, than any other samples. Besides, the adjusted  $R^2$  of Model 1.0\_S (row 6, column 4) is the largest amongst all models (Table 10.1, row 6). It indicates that the explanatory power provided by CGDscore for SmallCap firms is stronger than for any other firms. Voluntary CG disclosure, as measured by the CGDscore, has strong impact on market valuation for SmallCap firms.

The impact on firm valuation is less obvious in a sample that is composed of mixed LargeCap and MidCap firms. One possible explanation is that SmallCap firms may have an information environment which is different. If SmallCap firms were pooled together with LargeCap and MidCap firms, the effect on market valuation of the CGDscore would be diluted. This is consistent with the findings of previous CG studies where the CG disclosure is not found to have impact on firm's valuation for a pooled sample composed of firms with various sizes or market capitalizations. Prior studies may have come to the erroneous conclusion that CG disclosure has no impact on firm's valuation for any type of firms. By applying the same simple regression to different groupings of firms, this study demonstrates that, when the sampled firms are only composed of SmallCap firms, voluntary CG disclosure has a statistically significant and positive impact on firm's

valuation (Model 1.0\_S), which is hidden when the sample firms are pooled with other firms with different market capitalizations. Henceforth, this study adopts a compare-and-contrast approach in testing SmallCap firms with models *vis-a-vis* other pooled groups of sample firms with various market capitalizations.

Since the Intercepts in the models for all three partitioned samples (S, L+M+S, and L+M) are highly significant (Table 10.1, row 4, columns 4-6) at the 0.01 level, it seems that some variables may be missing in the models. The results imply that more explanatory variables are needed to account for a firm's valuation.

In order to test sub-hypothesis **H1b**, Model 1.0 is extended by including additional variables to form two extended models, Model 1.1 and Model 1.2, as follows:

- (i) adding the Corporate Governance practice variables into Model 1.0 such as the Board Size (BoDsize), the Number of Independent Non-Executive Directors (NumINED), the percentage of INEDs on the board (INED%), the Director Ownership (Dir%Own), the Split Role of Chairman and CEO (SplitRole), and the Dual Listing (DualList) as the explanatory variables, as represented by Model 1.1; and
- (ii) adding the Corporate Governance practice variables into Model 1.0 as stipulated in (i) above and the company characteristics (ComChar) variables such as the profitability in terms of Return on Equity (ROE), market strength in terms of Sales (LnSales), sustainable growth in terms of Sales Growth (W\_SalGrow), the firm's financial resources expressed in terms of total equity (LnEqty), and the leverage in terms of Debt/TA ratio (Debt/TA), as represented by Model 1.2.

The regression results of these extended models, Model 1.1 and Model 1.2, are presented in Section 10.3 and Section 10.4 respectively below.

### 10.3 Testing the effect of CG disclosure and CG variables on firm valuation

Model 1.0 is extended with the addition of the Corporate Governance Practice variables for testing sub-hypothesis **H1b**, which is re-stated from Chapter 8 as follows:

**H1b:** A firm's market valuation as proxied by  $Wq$  is a function of its CG disclosure and CG practices.

In functional form, Model 1.1 is represented as follows:

$$Wq_{i,t} = \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \beta_2 \Sigma \text{CGprac}_{i,t} + \varepsilon_{i,t} \dots \dots \dots (\text{Model 1.1})$$

where  $Wq$  is the approximation of Tobin's  $q$  as defined in Section 8.2.1 and winsorized at 5% and 95%. CGDscore is the firm's score of CG disclosure, and  $\Sigma \text{CGprac}$  denotes a set of CG practices variables as mentioned in Section 10.2.2 above.  $\beta_0 \dots \beta_2$  are the coefficients of the respective parameters; and  $\varepsilon, i, t$  are as defined previously. Results of Model 1.1 for all the sample groups are shown in Table 10.2 below.

**Table 10.2 Results of  $Wq$  regressed on CGDscore and CG Practices variables for the three samples. Dependent variable =  $Wq$ .**

	1	2	3	4
1 Model		1.1_LMS	1.1_LM	1.1_S
2 Sample		L+M+S	L+M	S
3 Observations		258	118	140
4 Intercept		<b>1.655*</b> (0.014)	1.714 (0.280)	<b>1.472*</b> (0.045)
5 CGscore		0.003 (0.377)	-0.001 (0.854)	<b>0.009*</b> (0.029)
6 BoDsize		-0.042 (0.432)	-0.014 (0.899)	-0.025 (0.718)
7 NumINED		-0.037 (0.821)	-0.303 (0.377)	-0.095 (0.660)
8 INED%		0.006 (0.726)	0.038 (0.369)	0.005 (0.773)
9 Dir%Own		-0.001 (0.650)	-0.007 (0.390)	-0.002 (0.515)
10 SplitRole		<b>0.390*</b> (0.012)	<b>0.707*</b> (0.016)	0.019 (0.911)
11 DualList		0.067 (0.673)	0.062 (0.808)	0.029 (0.884)
12 Adj. R <sup>2</sup>		0.028	0.083	0.005
13 Significance F		<b>0.047*</b>	<b>0.020*</b>	0.367

(Notes:  $P$ -values are shown in brackets. Coefficients are bold if  $p$ -values < 0.10; \* if  $p$ -values < 0.05; and \*\* if  $p$ -values < 0.01)

It can be seen from Table 10.2 that, for the Model 1.1\_LMS, the adjusted R<sup>2</sup> increases to 0.028 (row 12, column 2,) from 0.010 in Model 1.0\_LMS (Table 10.1, row 6, column 5), after the CG practices variables have been included in the model. Both the Intercept (Table 10.2, row 4, column 2) and SplitRole (row 10, column 2) are significant at the 0.05 level. Other parameters are not significant, suggesting that those CG practices such as Board Size, the number of INEDs on the board, the percentage of the board being INEDs, and the status of dual listing do not have much impact on a firm's valuation ( $Wq$ ) for the

L+M+S sample. The overall model, however, is significant at the 0.05 level as shown by the F significance (Table 10.2, row 13, column 2).

For Model 1.1\_LM (Table 10.2, column 3), the adjusted  $R^2$  is 0.083 (row 12, column 3) which is much higher than that of Model 1.1\_LMS (0.028). Unlike in the pooled sample, the Intercept is not significant at any reasonable level (row 4, column 3). The results show that the explanatory power of Model 1.1\_LM is higher than that of Model 1.1\_LMS. SplitRole (0.707, as shown in row 10, column 3) is positive and significant at the 0.05 level, similar to the case of the pooled sample. The result shows that firms that split the Chairman and CEO roles for large and medium size firms appear to have higher market valuation. However, this is not the case for small size firms.

For SmallCap firms, the regression results of Model 1.1\_S (Table 10.2, column 4) show an adjusted  $R^2$  of 0.005 (row 12, column 4). Nevertheless, the coefficient of CGDscore is positive (row 5) and highly significant ( $p$ -value = 0.029) at 0.05 level. Taking the findings of Model 1.0 and Model 1.1 together, the results suggest that a small firm's voluntary disclosure is significant in determining its market valuation ( $Wq$ ), before or after other CG practices variables are included in the regression model. The results seem to indicate that the market valuation of SmallCap firms is different from the market valuation of LargeCap or MidCap firms, controlling for variations in their CG practices.

SplitRole is the only CG practices variable that has statistically significant impact on a firm's valuation for LargeCap and MidCap firms (Table 10.2, row 10, column 3). No other CG practice variable has comparable significance. It may be interpreted that, firstly, the outside investors seem to value the splitting of the dual roles of the Chairman and CEO more importantly for larger firms than for small firms, probably because the concentration of power within the same individual for the two roles would lead to a more severe risk of expropriation of outside investors' interests. Secondly, splitting the dual roles of Chairman and CEO is considered the most important CG mechanism being installed within larger firms. Hence, sub-hypothesis **H1b**, which states that a firm's valuation is a function of its CG disclosure and its CG practices, is partially supported in the case of LargeCap firms and MidCap firms only. For the SmallCap firms, the CG practices variables have no impact on market valuation and hence **H1b** is not supported.

The third sub-hypothesis, **H1c** (see section 10.4 below), postulates that a firm's market valuation can also be affected by a firm's specific financial characteristics such as sales

revenue, sales growth, profitability, assets size, and leverage. These characteristics, known collectively as Company Characteristics (ComChar) variables in this study, are added into Model 1.1 to form Model 1.2, as discussed in the next section, Section 10.4.

#### 10.4 Testing the effect of CGDscore, corporate governance practices variables, and company characteristics on firm valuation

Hypothesis **H1c** aims to test whether the CGDscore and CG practice variables affect a firm's market valuation whilst controlling for the firm's financial performance and characteristics such as its profitability, sustainable income, growth prospect, market strength, and leverage. H1c is re-stated from Chapter 8 as follows:

**H1c:** A firm's valuation as proxied by  $Wq$  is a function of its CG disclosure and CG practices, controlling for company financial characteristics.

This sub-hypothesis is tested by Model 1.2. In this model, a firm's market value ( $Wq$ ) is regressed on its level of CG disclosure (CGDscore), CG Practices variables (CGprac), and Company Characteristics variables (ComChar). The model is presented in the condensed functional form as follows:

$$Wq_{i,t} = \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \beta_2 \Sigma \text{CGprac}_{i,t} + \beta_3 \Sigma \text{ComChar}_{i,t} + \beta_4 \text{Dir\%Own} + \varepsilon_{i,t} \quad (\text{Model 1.2})$$

$\Sigma \text{CGprac}$  denotes a set of CG practices variables as mentioned in Section 10.2.2.(i), and  $\Sigma \text{ComChar}$  denotes a set of company characteristics that contains variables that control for a firm's equity (LnEqty, the natural log of equity), Sales (LnSales, the natural log of sales), return on equity (ROE), debt/asset ratio expressed in percentage (Debt/TA), and sales growth (W\_SalGrow) expressed in percentage and winsorized at 5% and 95%;  $\beta_0$  is the intercept;  $\beta_1$ , and  $\beta_4$  are the coefficients for the estimated parameters;  $\beta_2$  and  $\beta_3$  are vectors for the coefficients of the respective parameters; and the other variables and subscripts are as defined previously.

Results of Model 1.2 for all the three sample groups are reported in Table 10.3 in the following page.

**Table 10.3 Results of  $Wq$  regressed on CGDscore, CG Practices variables and Company Characteristics variables for the three samples. Dependent variable =  $Wq$ .**

	1	2	3	4
1	Model	1.2_LMS	1.2_LM	1.2_S
2	Sample	L+M+S	L+M	S
3	Observations	258	118	140
4	Intercept	1.788 (0.190)	<b>7.266**</b> (0.002)	<b>7.900**</b> (0.000)
5	CGDscore	-0.001 (0.821)	<b>-0.007*</b> (0.025)	<b>0.008*</b> (0.030)
6	BoDsize	-0.021 (0.641)	-0.053 (0.397)	0.012 (0.844)
7	NumINED	0.034 (0.801)	0.002 (0.992)	-0.104 (0.586)
8	INED%	-0.004 (0.770)	-0.001 (0.965)	0.001 (0.963)
9	Dir%Own	0.001 (0.666)	-0.001 (0.890)	-0.001 (0.827)
10	SplitRole	<b>0.330**</b> (0.009)	<b>0.385*</b> (0.019)	-0.042 (0.779)
11	DualList	0.056 (0.674)	<b>0.327*</b> (0.026)	-0.042 (0.816)
12	ROE	<b>0.021**</b> (0.0001)	<b>0.027**</b> (0.0001)	<b>0.013**</b> (0.001)
13	LnSales	<b>0.302**</b> (0.0001)	<b>0.440**</b> (0.0001)	0.029 (0.694)
14	W_SalGrow	0.000 (0.628)	-0.001 (0.421)	0.000 (0.591)
15	LnEqty	<b>-0.293**</b> (0.0001)	<b>-0.605**</b> (0.0001)	<b>-0.324**</b> (0.0001)
16	Debt/TA	<b>-0.023**</b> (0.0001)	<b>-0.039**</b> (0.0001)	<b>-0.017**</b> (0.0001)
17	Adj. R <sup>2</sup>	0.361	0.736	0.255
18	Significance F	<b>0.0001**</b>	<b>0.0001**</b>	<b>0.0001**</b>

(Notes:  $P$ -values are shown in brackets. Coefficients are bold if  $p$ -values < 0.10; \* if  $p$ -values < 0.05; and \*\* if  $p$ -values < 0.01)

The regression results in Table 10.3 show that, with the inclusion of variables on company characteristics as control variables into the model, the adjusted  $R^2$  has improved. For the pooled L+M+S sample (Table 10.3, column 2), Model 1.2\_LMS shows the adjusted  $R^2$  has risen to 0.361 (row 17, column 2) from 0.028 in Model 1.1\_LMS (Table 10.2). For the combined L+M sample (Table 10.3, row 17, column 3), Model 1.2\_LM shows a rise in the adjusted  $R^2$  to 0.736 (row 17, column 3) from 0.083 in Model 1.1\_LM (Table 10.2). Similarly, for the sample of SmallCap firms, there is a rise in the adjusted  $R^2$  to 0.255 (row 17, column 4) from 0.005 in Model 1.1\_S (Table 10.2). The highest adjusted  $R^2$  is found in Model 1.2\_LM which is applied to the L+M sample. In sum, the regression results

show that it is the firm's financial characteristics that mainly explain the levels of a firm's market valuation, particularly in the combined sample of LargeCap and MidCap firms.

In the pooled L+M+S sample, it is noted that the CGDscore is not significant at any reasonable level in explaining the market valuation  $Wq$  (Table 10.3, row 5, column 2). In contrast, the CGDscore is highly significant at 0.05 level for the combined L+M sample (Table 10.3, row 5, column 3) and for the sample of SmallCap firms (row 5, column 4), though in opposite direction as indicated by the different signs. This may have several interpretations. First, the results suggest that, for the SmallCap firms in the S sample, a higher disclosure level enhances the firm's valuation, controlling for similar company characteristics in terms of profitability, sales income, sales growth, and leverage. By being more transparent about its CG practices, a small firm stands to enjoy a higher market valuation than its counterparts with less CG transparency, *ceteris paribus*. This empirical evidence lends further support to the notion that, for the small firms, the information asymmetry between insiders and outsiders is such a major concern for the outside investors that any voluntary actions by the management in reducing the information gap will be appreciated and reflected in market value improvements.

Second, for the L+M sample, the CGDscore affects the market valuation negatively, as the company characteristics variables are included in the model. The evidence seems to suggest that, for a large or medium size firm, there appears to be an inverse relationship between firm value and voluntary governance disclosure, whereas the opposite is the case for a small firm. This may be due to the extent of information asymmetry prevalent in the two subgroups of firms. It suggests that, as the information about small firms is relatively scarce, outsiders may welcome more information voluntarily disclosed about the CG by a small firm and thus react in a positive manner in terms of the firm's market valuation. In the case of L+M firms, however, the information set available to outsiders may be sufficiently large, so that more voluntary disclosure of CG information may not be new or novel to the outsiders. Furthermore, voluntary disclosure likely incurs more costs in preparation but may not be providing much incremental value-added information to the outsiders.

Thirdly, the opposing effect of CGDscore on valuation for LargeCap/MidCap firms and for SmallCap firms may be attributable to the difference in the levels of insider ownership of the firm. As discussed in Chapter 9, SmallCap firms tend to have a predominant insider

ownership (the mean of the Dir%Own for the study period is 50.82% as per Table 9.8), which is higher than that for the LargeCap firms (45.54% as per Table 9.2) and also higher than that for the sample of LargeCap and MidCap firms combined<sup>2</sup>. In circumstances where predominant ownership prevails (as in the case of SmallCap firms), more voluntary disclosure is a signal which indicates that insiders are more willing to share the information with outsiders.

Finally, the collinearity issue offers another possible explanation for the opposing signs of the coefficients of CGDscore for the sample of L+M firms and the sample of S firms in Table 10.3 (column 3 and 4, respectively). The CGDscore may be collinear to other explanatory variables, which may have different levels of impact on the dependent variable collectively, as well as on each other individually. For SmallCap firms, the CGDscore is found to be significantly correlated with BoDsize (Table 9.9), but it is not the case for LargeCap firms (Table 9.3) or MidCap firms (Table 9.6). Furthermore, the CGDscore is significantly correlated with SplitRole for SmallCap firms, but it is not so for MidCap firms and is only marginally significant for LargeCap firms. As a result, the aggregate impact on the dependent variable may be manifested in opposing directions when the same explanatory variables are applied to different samples.

Ideally, all explanatory variables in a regression model should not be correlated. In reality, every multiple regression model will contain some degree of correlation among its explanatory variables (Asteriou and Hal, 2007, p. 89). The issue at hand is to assess whether the degree of multi-collinearity in the model is sufficiently high as to create any problems in interpreting the findings in an appropriate manner.<sup>3</sup>

Two other CG practice variables, the split of roles between Chairman and CEO (SplitRole) and dual listing (DualList), are also found to be significant for the larger firms (Table 10.3, row 10, columns 2 and 3; and row 11, column 3) but not significant for the smaller firms. The evidence suggests that splitting the roles of Chairman and CEO is deemed to be a more important CG practice by investors for larger firms than for small firms, as such CG

<sup>2</sup> The mean of the Dir%Own for the combined sample of LargeCap and MidCap firms can be directly computed by data extracted from Table 9.2 and Table 9.5:  $[(36 \times 45.54\%) + (82 \times 52.06\%)] / (36 + 82) = 50.07\%$ .

<sup>3</sup> Collinearity problem exists when one or more of the explanatory variables in a multiple regression are highly correlated with each other. In such situations, it becomes difficult to separate the effect of such variables on the dependent variable. One sign of collinearity problem is that when some explanatory variables are included in the model, the values of the regression coefficients for the correlated variables fluctuate drastically. A multicollinearity analysis using Variance Inflation Factor (VIF) on Model 1.2\_LM is presented in Appendix 6, which shows that NumINED are highly correlated with INED%.



practice enhances a larger firm's valuation. This is consistent with the view that, for larger firms with more complex business activities, insiders have more opportunities to expropriate outside investors' wealth.

Dual listing (DualList) is a significant factor in affecting the market value of a firm for the sample of L+M firms, when the ComChar variables are included in the model (Table 10.3, row 11, column 3). From the standpoint of corporate governance, by seeking dual listing, a firm is subject to the scrutiny of the regulations of an additional stock exchange. It often results in improved internal corporate governance and higher accounting standards of the firm. Minority shareholders would expect to find themselves better protected when investing in cross-listed firms, and they show their favourable sentiment towards those firms by according a higher market value to the firm. In contrast, DualList is not found to be significant in value relevance for SmallCap firms (Table 10.3, row 11, column 4). The paucity of SmallCap firms that have dual listing status may be a reason why the statistical significance is meaningless.

Three control variables within the Company Characteristics (ComChar) category, namely, the Return on Equity (ROE), the natural log of a firm's equity (LnEqty), and the Debt to Total Assets ratio (Debt/TA), are found to be significant for the firms of both the L+M sample and the S sample (Table 10.3, and Model 1.2\_LM and Model 1.2\_S, respectively). For the ROE, the signs of the estimated coefficients are positive (row 12, column 3 and 4), indicating that a firm's profitability is a key factor that determines its market valuation. For the LnEqty and Debt/TA, the signs of their coefficients are negative for both samples, implying that their impact on market valuation is in the same direction.

However, another ComChar variable, LnSales, is found to be significant for the firms in the L+M+S sample and the L+M sample (Table 10.3, row 13, columns 2 and 3) but not for the sample of small firms. It implies that sustainable income has more significant influence on a firm's market valuation for larger firms than for smaller firms.

The statistically significant variables of the extended models of Model 1.2 are summarized in Table 10.4 below. The signs of the coefficients are reported in brackets after the names of the variables that are statistically significant (with p-value < 0.10).

**Table 10.4 Summary of statistically significant variables in Model 1.2. Dependent variable =  $Wq$ .**

Model	1.2_LMS	1.2_LM	1.2_S
Sample	L+M+S	L+M	S
CGDscore	--	CGDscore (-)	CGDscore (+)
CG Practices variables:			
- DualList	--	DualList (+)	--
- SplitRole	SplitRole (+)	SplitRole (+)	--
Company Characteristics variables:			
- ROE	ROE (+)	ROE (+)	ROE (+)
- LnSales	LnSales (+)	LnSales (+)	--
- LnEqty	LnEqty (-)	LnEqty (-)	LnEqty (-)
- Debt/TA	Debt/TA (-)	Debt/TA (-)	Debt/TA (-)

(Notes: Variables that are found significant in any one of the three models are reported if their  $p$ -value  $< 0.10$ , and are denoted by "--" if otherwise. The sign of the coefficient of the variable is shown in brackets)

The summary presented in Table 10.4 shows that, to a large extent, the  $Wq$  is influenced by a firm's financial performance such as profitability (ROE), sustainable income (LnSales), and its capital structure (such as LnEqty and Debt/TA). Hence, Hypothesis **H1c**, which postulates that a firm's  $q$  is affected by its CG disclosure and CG practices, controlling for company financial characteristics, is partially supported for LargeCap and MidCap firms, but not for SmallCap firms.

As suggested in prior research studies, a firm's ownership structure is a factor affecting a firm's  $Wq$ . Agency theory also suggests that ownership structure is closely linked to the corporate governance of a firm. Therefore, a firm's valuation can be affected by both its ownership structure and CG jointly, as stated in the sub-hypothesis **H1d** in Chapter 8. Model 1.3 in the following section sets out to test such hypothesis.

## 10.5 Testing the effect of CG practices, company characteristics, and joint CG ranking with ownership structure on firm valuation

As per Chapter 8, Hypothesis H1d postulates that the ranking of a firm's CG and the level of insiders' ownership can jointly affect a firm's market valuation. **H1d** is re-stated as follows:

**H1d:** Low CG rank firms have lower  $q$ , controlling for the level of insiders' ownership.

To test **H1d** using Model 1.3,  $Wq$  is regressed on the firm's CG practices (CGprac) variables, company characteristics (ComChar) variables, as well as dummy variables for its joint CG ranking and Director Ownership. The condensed functional form is given by:

$$Wq_{i,t} = \beta_0 + \beta_1 \Sigma CGprac_{i,t} + \beta_2 \Sigma ComChar_{i,t} + \beta_3 \Sigma CG\_RankOwn_{i,t} + \varepsilon_{i,t} \quad (\text{Model 1.3})$$

$Wq$ ,  $\Sigma CGprac$ , and  $\Sigma ComChar$  are as defined in previous sections above.  $CG\_RankOwn$  is a variable expressed as a joint variable of CG ranking and director's ownership of a firm, as defined in Section 8.8.3 in Chapter 8.  $\beta_0$  is the intercept;  $\beta_1 \dots \beta_3$  are vectors for the coefficients of the respective parameters; and  $\varepsilon, i, t$  are as defined previously. Firms are firstly ranked into 2 classes by their CG disclosure with reference to their median: (i) Low  $CG\_rank$  and (ii) High  $CG\_rank$ , making reference to the median of the CGDscore of the sampling frame. The firms are then classified into 3 categories of Director Ownership (Dir%Own): (a) Low (if Dir%Own < 25%); (b) Medium (if Dir%Own is 25-50%); and (c) Predominant (if Dir%Own > 50%).

A 2 x 3 matrix is constructed with six joint  $CG\_Rank$  and Dir%Own Groups, with dummy variables assigned to each of the six joint  $CG\_rank$  and Dir%Own Groups as discussed in Section 8.8.3 in Chapter 8. For quick reference, these six joint groups as shown in Table 8.3 are reproduced in Table 10.5 below:

**Table 10.5 A 2x3 matrix on CG ranking and Director's Ownership of a firm**

	Director Ownership (Dir%Own)		
CG_rank (vs. median)	Low (0-25%)	Medium (25-50%)	Predominant (50%+)
High	HL	HM	HP
Low	LL	LM	LP

As previously discussed in Chapter 8, the High- $CG\_Rank$ -and-Low-Dir%Own (HL) group in Table 10.5 above is selected as the base category for comparison with the other five  $CG\_RankOwn$  groups: HM, HP, LL, LM, and LP. Five dummy variables are respectively assigned to them: DV\_HM, DV\_HP, DV\_LL, DV\_LM, and DV\_LP. These dummy variables act as the explanatory variables to test the extent of the market valuation of a firm ( $Wq$ ) being affected by the joint characteristics of CG ranking and Director Ownership.

Model 1.3 and its various specifications are then applied to the three partitioned samples of L+M+S, L+M, and S firms. The regression results are shown in Table 10.6 below. As discussed in Section 8.8.3, there is no entry for the variable DV\_LL in the sample of combined L+M firms (Table 10.6, row 17, column 3) because there is no observation in the sample that fits in the category of Low CG rank and Low Directors' Ownership.

**Table 10.6 Results of  $Wq$  regressed on CG Practices variables, Company Characteristics variables, and the joint CG\_RankOwn dummy variables for the three samples. Dependent variable =  $Wq$ .**

	1	2	3	4
1	Model	1.3_LMS	1.3_LM	1.3_S
2	Sample	L+M+S	L+M	S
3	Observations	258	118	140
4	Intercept	1.869 (0.176)	<b>5.571*</b> (0.025)	<b>8.016**</b> (0.000)
5	BoDsize	-0.020 (0.648)	-0.014 (0.825)	0.022 (0.720)
6	NumINED	0.016 (0.905)	-0.152 (0.444)	-0.149 (0.451)
7	INED%	-0.004 (0.791)	0.017 (0.500)	0.004 (0.797)
8	SplitRole	<b>0.270*</b> (0.033)	<b>0.346*</b> (0.037)	0.004 (0.976)
9	DualList	0.023 (0.866)	<b>0.307</b> (0.034)	-0.081 (0.658)
10	ROE	<b>0.020**</b> (0.0001)	<b>0.025**</b> (0.001)	<b>0.014**</b> (0.0001)
11	LnSales	<b>0.297**</b> (0.000)	<b>0.451**</b> (0.000)	0.036 (0.638)
12	W_SalGrow	0.000 (0.783)	-0.001 (0.638)	0.000 (0.571)
13	LnEqty	<b>-0.284**</b> (0.0001)	<b>-0.583**</b> (0.0001)	<b>-0.312**</b> (0.001)
14	Debt/TA	<b>-0.024**</b> (0.0001)	<b>-0.040**</b> (0.0001)	<b>-0.015**</b> (0.002)
15	DV_HM	0.106 (0.640)	0.229 (0.479)	-0.390 (0.159)
16	DV_HP	-0.025 (0.904)	0.055 (0.864)	-0.289 (0.184)
17	DV_LL	-0.371 (0.181)	n.a.	<b>-0.486</b> (0.059)
18	DV_LM	0.068 (0.753)	0.507 (0.126)	<b>-0.452</b> (0.055)
19	DV_LP	-0.128 (0.532)	0.082 (0.803)	<b>-0.560*</b> (0.016)
20	Adj. R <sup>2</sup>	0.363	0.735	0.248
21	Significance F	<b>0.0001**</b>	<b>0.0001**</b>	<b>0.0001**</b>

(Notes:  $P$ -values are shown in brackets. Coefficients are bold if  $p$ -values < 0.10; \* if  $p$ -values < 0.05; and \*\* if  $p$ -values < 0.01)

For the pooled L+M+S sample (Table 10.6, column 2, Model 1.3\_LMS), the CG Practices variable SplitRole (row 8, column 2), as well as four of the Company Characteristics variables (ROE, LnSales, LnEqty, and Debt/TA as shown respectively in rows 10, 11, 13, and 14, column 2, of Table 10.6), are found to be statistically significant in explaining the market valuation of a firm. However, none of the joint CG\_RankOwn dummy variables are significant (rows 15-19, column 2).

Similar results are obtained for Model 1.3\_LM for the L+M sample (Table 10.6, column 3). The same four Company Characteristics variables (i.e., ROE, LnSales, LnEqty, and Debt/TA) continue to be statistically significant in affecting a firm's market valuation. In addition, dual listing (DualList) is also found to be significant in Model 1.3\_LM (Table 10.6, row 9, column 3). Similar to the results of Model 1.3\_LMS, none of the joint CG\_RankOwn dummy variables are found to be significant for Model 1.3\_LM (rows 15-19, column 3).

A different empirical result is obtained from the Model 1.3\_S on the sample of SmallCap firms (Table 10.6, column 4, Model 1.3\_S). Of the five dummy variables (DV\_HM, DV\_HP, DV\_LL, DV\_LM, and DV\_LP) that investigate the joint effect of CG ranking and directors' ownership for the firm, three of them are found to be significant at the 0.10 level (Table 10.6, rows 17 – 19, column 4). Such phenomenon is not found for the other two samples. Furthermore, all the variables of Low CG ranking (DV\_LL, DV\_LM, and DV\_LP) have negative coefficients (rows 17-19, column 4), when compared to the base category of HL firms (characterized with High-in-CG ranking but Low-in-directors' ownership). It implies that SmallCap firms with lower CG ranking are generally associated with a lower market valuation than that of high CG ranking firms.

Although the coefficients on DV\_HM and DV\_HP in Model 1.3\_S (Table 10.6, rows 15 and 16, column 4) are also negative, they are not statistically significant. Hence, the groups of HM and HP firms may not necessarily have exhibited a lower market valuation than the HL base group of SmallCap firms.

Table 10.7 summarizes the coefficients of the various dummy variables of the joint CG\_RankOwn groups for the sample of SmallCap firms:

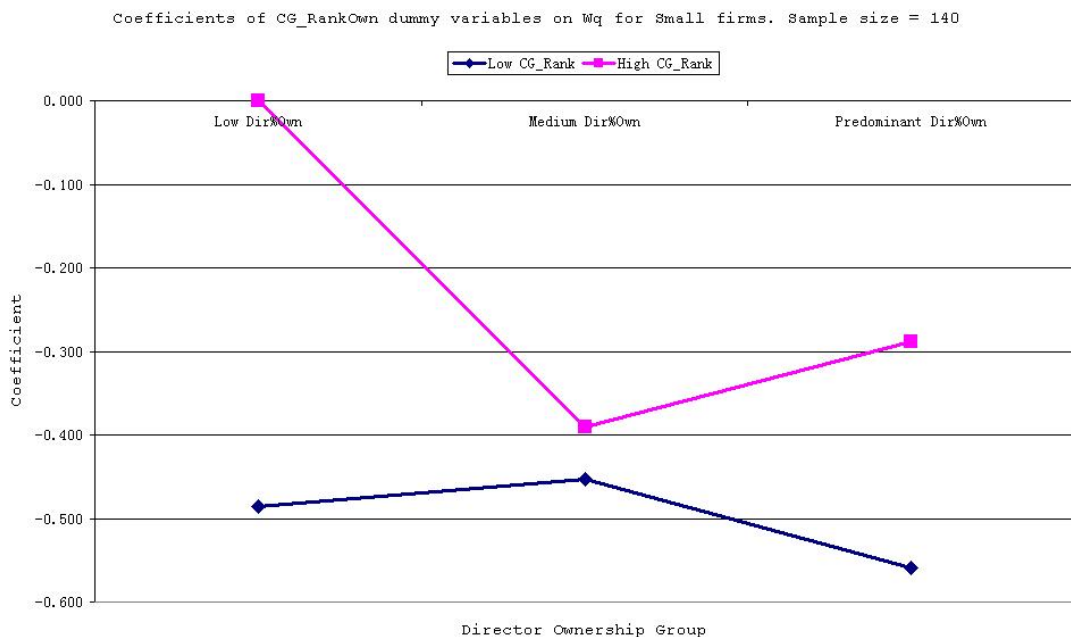
**Table 10.7 Summary of the coefficients of dummy variables of the CG\_RankOwn groups of Small firms on  $Wq$**

	Director Ownership (Dir%Own)		
CG_rank	Low (0-25%)	Medium (25-50%)	Predominant (50%+)
High	0 (0.159)	-0.390 (0.159)	-0.289 (0.184)
Low	<b>-0.486</b> (0.059)	<b>-0.452</b> (0.055)	<b>-0.560*</b> (0.016)

(Notes:  $P$ -values are shown in brackets. Coefficients are bold if  $p$ -values < 0.10; \* if  $p$ -values < 0.05; and \*\* if  $p$ -values < 0.01)

Figure 10.2 below is a graphical presentation of Table 10.7 that offers several interpretations of these coefficients. The line above (in pink) denotes the firms with high CG ranking. The line below (in blue) denotes the firms with low CG ranking. The  $x$ -axis denotes the category of directors' ownership (Dir%Own) from low, to medium, and to predominant level, whereas the  $y$ -axis denotes the coefficients of the dummy variables with reference to the firm's market valuation  $Wq$ .

**Figure 10.2 Coefficients of dummy variable of CG rank and directors' ownership on firm valuation for SmallCap firms. Dependent variable =  $Wq$ .**



Firstly, as shown in Figure 10.2, there is a higher coefficient for market value ( $Wq$ ) for high CG ranking firms than for low CG ranking firms *across all levels of directors' ownership* (Dir%Own). Stated differently, higher CG ranking firms are always associated with higher market valuation ( $Wq$ ), compared to those firms with similar level of directors' ownership but with a lower CG ranking (the pink line segment is always above the blue line segment in Figure 10.2).

Secondly, the biggest gap between high CG ranking firms and low CG ranking firms in terms of the coefficient for market valuation is found where the level of directors' ownership (Dir%Own) is low (i.e., < 25%). The difference of the coefficients between HL and LL firms is 0.486, which is the largest as compared with the same between HM and LM firms (0.062) and the same between HP and LP firms (0.271)<sup>4</sup>. It suggests that, for those small firms characterised with low insider ownership, more voluntary disclosure on the CG practices tends to bring about a big increase on the firm's market valuation, *ceteris paribus*. Therefore, if SmallCap firms are to change their disclosure behaviour about their CG practices, it is likely that their firms' market valuation will be changed accordingly. The magnitude of the change in market valuation, however, will vary with the level of insiders' ownership.

Thirdly, it can be seen from Figure 10.2 that, for SmallCap firms with high CG ranking, there is a V-shaped relationship in terms of the coefficient of market valuation and directors' ownership. It seems to suggest that the relationship between market valuation ( $Wq$ ) and insiders' ownership is not linear. For high CG ranking small firms, the market value will firstly decrease with directors' ownership and then increases when directors' ownership reaches a level of 50% or above. Investors, in general, seem to assign a higher market value to a small firm when there is a predominant shareholder, provided that it has a high CG disclosure ranking, than a small firm with a medium level of insider ownership. Presumably, the presence of a predominant shareholder adds more value to a small firm, provided the management is transparent (i.e., disclosing a high level of information) about its CG practices.

Conversely, an inverted "V" shaped relationship is observed for those small firms with low CG ranking. The market valuation ( $Wq$ ) of a small firm rises with insider ownership, but starts to decline when insider ownership reaches a level where entrenchment of managers would become a concern for the outside investors. The relationship between  $Wq$  and Dir%Own for low CG ranking firms as depicted in Figure 10.2 seems to be consistent with the hypotheses as postulated by the classical agency theory in prior literature.

In sum, the market valuation for small firms varies with the percentage of insider ownership. The pattern of valuation differs, depending jointly on the firm's voluntary

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<sup>4</sup> The difference can be found by comparing the coefficients as stated in row 3 and row 4 of Table 10.7.

disclosure of its CG practises and its level of insider ownership. If the firm has low level of insider ownership but is transparent in its CG disclosure, it is associated with a high market valuation. However, if the firm has a predominant shareholder but is ranked poor in terms of CG disclosure, it has low market valuation. The above-mentioned relationships are found for sample firms in Hong Kong where there is strong legal protection of minority investors' rights. It suggests that, even if the strong legal protection is taken for granted, investors will still look for other indicators (such as the voluntary disclosure of CG information and director's ownership) as a guide for seeking additional protection for their investment. If a firm tends to have entrenchment problems and low transparency about its CG practices, investors will not be expected to pay a high market price for its shares. The aspirations of outside investors are reflected in a firm's market valuation.

The summarized results of the extended versions of Model 1.3 are tabulated in Table 10.8 below.

**Table 10.8 Summary of statistically significant variables in Model 1.3.**  
Dependent variable =  $Wq$ .

Model	1.3_LMS	1.3_LM	1.3_S
Sample	L+M+S	L+M	S
CG Practices variables: - DualList - SplitRole	-- SplitRole (+)	DualList (+) SplitRole (+)	-- --
Company Characteristics variables - ROE - LnSales - LnEqty - Debt/TA	ROE (+) LnSales (+) LnEqty (-) Debt/TA (-)	ROE (+) LnSales (+) LnEqty (-) Debt/TA (-)	ROE (+) -- LnEqty (-) Debt/TA (-)
Dummy variables - DV_LL - DV_LM - DV_LP	-- -- --	-- -- --	DV_LL (-) DV_LM (-) DV_LP (-)

(Notes: Variables that are found significant in any one of the three models are reported if their  $p$ -value  $< 0.10$ , and are denoted by "--" if otherwise. The sign of the coefficient of the variable is shown in brackets)

Generally speaking, SmallCap firms with a higher CG ranking are found to be related to a higher market valuation ( $Wq$ ) than firms with a low CG ranking, across all levels of director's ownership. For LargeCap and MidCap firms, however, the findings are not conclusive. All in all, Hypothesis **H1d**, which postulates that low CG rank firms have lower  $q$ , controlling for the level of insiders' ownership, is strongly supported in the case of SmallCap firms.



To ascertain the outcome of the regression results obtained in Model 1.3, a robustness test is conducted with regard to the classification of SmallCap firms into 6 different joint categories of CG\_RankOwn, using a non-parametric Kruskal-Wallis Rank Test. A further check on the regression results of Model 1.3 for the S sample and the L+M sample is performed through the plotting of scatter diagrams of  $Wq$  against Dir%Own, which are depicted as continuous variables rather than categorical variables. The results of both robustness tests show the regression results of Model 1.3 are valid (see Section 10.10 in this Chapter).

The following section, Section 10.6, discusses the empirical results of Model 2 and its extensions, using CG disclosure score (CGscore) as the dependent variable.

## 10.6 Testing the effect of CG practices and company characteristics on CG disclosure

As discussed in Chapter 6, Hypothesis 2 (*H2*) postulates that the level of voluntary CG disclosure by a firm is influenced by factors closely related to its CG practices, such as the number of INEDs on the board, the duality roles of Chairman and CEO, and the status of cross listing of the firm. For quick reference, *H2* is quoted from Chapter 6 as follows:

*H2*: The level of voluntary CG disclosure is influenced by the CG practices within the firm and the level of insiders' ownership whilst controlling for the firm's performance and capital structure.

To empirically test *H2*, it is necessary to decompose it into five supplementary hypotheses, as stated in Section 8.8.4 of Chapter 8, which are re-stated as follows:

***H2a***: A firm's voluntary CG disclosure is negatively related to the insiders' ownership (Dir%Own).

***H2b***: A firm's voluntary CG disclosure is positively related to the number of INEDs (NumINED) and the percentage of INEDs (INED%) sitting on the board, *ceteris paribus*.

***H2c***: A firm's voluntary CG disclosure is positively related to the firm's resources (LnTA), controlling for profitability, sales, and leverage.

***H2d***: Firms that are cross-listed voluntarily disclose more CG information.

***H2e***: Firms that split the roles of Chairman and CEO have a higher voluntary CG disclosure.

Correspondingly, Model 2.0 (as stated in Chapter 8) is used to investigate as to whether the CG disclosure of a firm is affected by the CG practices and the company characteristics of a firm. The variable representing CG disclosure, CGDscore, becomes the dependent variable. The condensed functional form of Model 2.0 is stated as below:

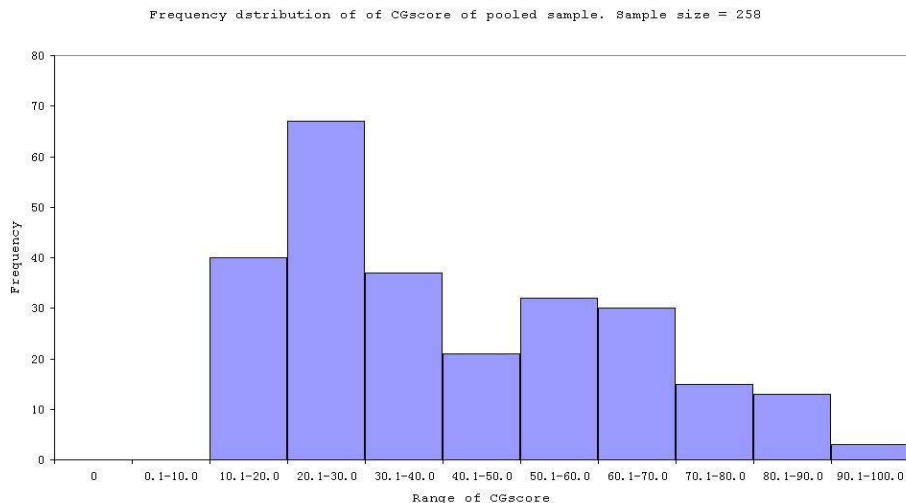
**Model 2.0**

$$CGDscore_{i,t} = \beta_0 + \beta_1 \Sigma CGprac_{i,t} + \beta_2 \Sigma ComChar2_{i,t} + \varepsilon_{i,t} \dots \dots \dots (\text{Model 2.0})$$

where  $\Sigma CGprac$  is the set of CG practice variables,  $\Sigma ComChar2$  is the set of company characteristics variables as defined in Section 10.4 (except that in Model 2.0, LnEqty is replaced by LnTA (the natural log of total assets)<sup>5</sup>.  $\beta_0$  is the intercept;  $\beta_1 \dots \beta_3$  are vectors for the coefficients of the respective parameters; and  $\varepsilon, i, t$  are as defined previously. The regression model is applied to the pooled L+M+S sample, the combined L+M sample, and the S sample.

The distribution of the dependent variable, CGDscore, is preliminarily tested by the 3-standard deviation rule to identify if there are any outliers. No outlier is detected (mean = 41.96, standard deviation = 21.59) in the L+M+S sample, L+M sample, or the sample of SmallCap firms. Hence, no winsorization of CGDscores for any of the three samples of firms is required. A visual inspection of the frequency distribution of CGDscore for the pooled L+M+S sample is presented in Figure 10.3 below:

**Figure 10.3 Frequency distribution of CGDscore for the pooled L+M+S sample. Sample size = 258.**



<sup>5</sup> Total Assets (TA) is a proxy for the resources under a firm's control. By definition, TA will also incorporate two components, the liabilities and the equity of the firm. The higher liabilities a firm has, the more likely the debt holders (who as stakeholders) may affect the management's willingness for voluntary CG disclosure. If CGDscore is regressed on LnTA, it will be unclear whether the regression is attributed to the liabilities or the equity component. Hence, it is preferably to use LnEqty to proxy for a firm's resources as an explanatory variable in regression models where CGscore is the dependent variable.

The regression results of Model 2.0 applied to the three samples are shown in Table 10.9.

**Table 10.9 Results of CGDscore regressed on CG Practices variables and Company Characteristics variables for the three samples of firms. Dependent variable = CGDscore.**

	1	2	3	4
1	Model	2.0_LMS	2.0_LM	2.0_S
2	Sample	L+M+S	L+M	S
3	Observations	258	118	140
4	Intercept	0.118 (0.997)	-19.170 (0.804)	-41.005 (0.423)
5	BoDsize	-0.198 (0.840)	-1.740 (0.368)	1.377 (0.346)
6	NumINED	3.064 (0.295)	6.481 (0.284)	0.910 (0.842)
7	INED%	0.061 (0.850)	-0.352 (0.639)	0.315 (0.434)
8	Dir%Own	<b>-0.160**</b> (0.005)	-0.047 (0.718)	<b>-0.165*</b> (0.014)
9	SplitRole	<b>10.873**</b> (0.0001)	<b>8.577</b> (0.085)	<b>13.191**</b> (0.0001)
10	DualList	-1.010 (0.731)	-1.415 (0.750)	-1.567 (0.716)
11	ROE	<b>0.272**</b> (0.002)	<b>0.447*</b> (0.033)	<b>0.236*</b> (0.014)
12	LnSales	1.304 (0.306)	0.298 (0.896)	1.755 (0.329)
13	W_SalGrow	-0.012 (0.494)	-0.042 (0.216)	0.004 (0.835)
14	LnTA	-0.169 (0.903)	2.108 (0.487)	0.505 (0.811)
15	Debt/TA	<b>0.147</b> (0.075)	0.153 (0.234)	0.104 (0.394)
16	Adj. R <sup>2</sup>	0.183	0.127	0.197
17	Significance F	<b>0.0001**</b>	<b>0.007**</b>	<b>0.0001**</b>

(Notes: *P*-values are shown in brackets. Coefficients are bold if *p*-values < 0.10; \* if *p*-values < 0.05; and \*\* if *p*-values < 0.01)

For the pooled L+M+S sample (Table 10.9, column 2, Model 2.0\_LMS), the results indicate that splitting the roles of Chairman and CEO (SplitRole, as shown in row 9, column 2) is positively related to the level of CG disclosure (CGDscore) and is statistically significant at 0.01 level. This is consistent with the hypothesis that splitting the dual roles of Chairman/CEO will provide checks and balance to the power distribution within the firm's governance environment; hence leads to *increases* in the voluntary CG disclosure.

Results of Model 2.0\_LMS also indicate a negative coefficient for Dir%Own (Table 10.9, row 8, column 2). It suggests that the higher the insiders' ownership, the lower is the voluntary disclosure of CG. This is consistent with the notion that, within a firm with concentrated ownership, the owners tend to share the CG information with the insiders, and do not feel obliged to disclose such information to the outsiders.

As regards the Company Characteristics (ComChar) variables, two control variables – Debt/Asset ratio (Debt/TA) and Return on Equity (ROE) – are found to be positively related to CGDscore and both are significant at the 0.10 level, suggesting that leverage and profitability are significant factors in voluntary governance disclosure. With a higher Debt/TA ratio in the firm, managers are expected to be more intensely monitored by the debt-holders; hence may feel obliged to voluntarily disclose more about the firm's state of CG so as to put the debt-holders at ease. On the other hand, the association of higher profitability (represented by a higher ROE) with a higher disclosure of CG may reflect the high quality and business acumen of the firm's management. Good quality managers tend to appreciate the importance of CG to their stakeholders and would not be afraid to disclose more.

Comparing the results observed from the three samples in Table 10.9, it can be shown that the factors that are significant in affecting CGDscore are similar. SplitRole and ROE are positively related to the CGDscore, while Dir%Own is negatively related to the CGDscore for SmallCap firms as well (Table 10.9, column 4). It is noted that for the combined L+M sample (Table 10.9, column 3, Model 2.0\_LM), the negative relationship between directors' ownership and CG disclosure (row 8, column 3) does not seem to be significant at 0.10 level. Yet, in the pooled L+M+S sample and in the SmallCap firms sample, the negative relationship is significant (row 8, column 2 and 4) at 0.05 level. As such, it may be interpreted that the significant relationship between the two variables found in the L+M+S sample may be induced by the overwhelming proportion of SmallCap firms in the pooled sample.

The significant results of Model 2.0 and its extended models are summarized and tabulated in Table 10.10 below. It can be seen from Table 10.10 that SplitRole is a governance factor that positively affects a firm's voluntary CG disclosure. Profitability of the firm, as proxied by the variable ROE, is yet another Company Characteristic factor that would affect positively a firm's voluntary CG disclosure.

**Table 10.10 Summary of statistically significant variables in Model 2.0. Dependent variable = CGDscore.**

Model	2.0_LMS	2.0_LM	2.0_S
Sample	L+M+S	L+M	S
CG Practices variables: - SplitRole - Dir%Own	SplitRole (+) Dir%Own (-)	SplitRole (+) --	SplitRole (+) Dir%Own (-)
Company Characteristics variables: - ROE - Debt/TA	ROE (+) Debt/TA (+)	ROE (+) --	ROE (+) --

(Notes: Variables that are found significant in any one of the three models are reported if their  $p$ -value  $< 0.10$ , and are denoted by "--" if otherwise. The sign of the coefficient of the variable is shown in brackets)

The summary Table 10.10 shows that Director's ownership (Dir%Own) is negatively associated with CGDscore for firms in the S sample and in the pooled sample. The result indicates that the higher the insider ownership, the lower is the voluntary CG disclosure. Hence, Hypothesis **H2a**, that states a firm's voluntary CG disclosure is negatively related to the insiders' ownership, is generally supported.

On the other hand, the number of INEDs sitting on the board of directors (NumINED) or the percentage of INEDs of the total number of directors (INED%) are not found to be significant at any reasonable level of confidence. Hence, the hypothesis **H2b**, that suggests a firm's voluntary CG disclosure is positively related to the number of INEDs (NumINED) and the percentage of INEDs (INED%) sitting on the board, *ceteris paribus*, is not supported.

The variable, the natural log of total assets (LnTA), is not found to be significant at 0.10 level in either the combined L+M sample or the sample of SmallCap firms (S). There is no evidence to support that a firm's resources have an effect on the CG disclosure (CGDscore) of a firm. Hence, Hypothesis **H2c** that proposes a firm's voluntary CG disclosure is positively related to the firm's resources (LnTA), controlling for profitability, sales, and leverage, is not supported.

The coefficient on cross listing (DualList) in Model 2.0\_LMS, Model 2.0\_LM or Model 2.0\_S is not statistically significant in the models. There is no variable in Model 2.0 and its extensions to suggest that a firm being cross-listed (DualList) is associated with the voluntary CG disclosure in the models. Hence, Hypothesis **H2d**, which states that cross-listed firms voluntarily disclose more CG information, is not supported.

Finally, the split of roles of Chairman and CEO (SplitRole) is found to be statistically significant in the L+M sample as well as in the S sample. Hence, hypothesis **H2e**, which suggests that firms with split roles of Chairman and CEO have a higher voluntary CG disclosure, is supported.

## 10.7 Testing systematic differences amongst the three samples

In Chapter 8, Hypothesis 3 (*H3*) postulates that:

### Hypothesis 3

*H3*: There are systematic differences in the voluntary CG disclosure between LargeCap firms and SmallCap firms in both the level of disclosure and the value relevance of disclosure.

A pair-wise *t*-test has already been conducted in Section 9.5 of Chapter 9 amongst different market capitalizations of firms, across the years, with respect to the key research variables such as CGDScore, *q*, DivPay, and Dir%Own. The preliminary results show that there are significant year-on-year differences (at the 0.05 level) within each capitalization group of firms in the CGDScore; and there are also some significant year-on-year differences (at the 0.10 level) on DivPay (Table 9.10 in Chapter 9). As regards the pair-wise comparison between different capitalizations of firms, there are also significant differences (at the 0.10 level) between MidCap firms and SmallCap firms in terms of CGDScore, *q*, and DivPay for various years (Table 9.11 in Chapter 9). Only in terms of DivPay in year 2003 are significant differences (at the 0.05 level) found between LargeCap and SmallCap firms.

Although a *t*-test may be valid and sufficient for a pair comparison, in a family or group of pair comparisons, a *t*-test may be incapable of distinguishing a significant difference without jeopardizing the overall, group-wise, level of confidence. For instance, if a 0.05 level is selected as the threshold for rejecting the null hypothesis, a series of pair comparisons between A and B, B and C, and A and C may show there is no significance at 0.05 level separately, suggesting that A, B, C are not different from each other. However, the *joint* level of significance is lowered to  $0.95 \times 0.95 \times 0.95 = 0.86$ , meaning that the threshold for rejecting the null hypothesis is relaxed to  $1.00 - 0.86 = 0.14$ , which is far less stringent than the original 0.05 level. In this section, an ANOVA test (which allows a group-wise *t*-test) is applied to the sample firms on three aspects: (i) the level of CG

disclosure, (ii) market valuation of firms as proxied by Tobin's  $q$ , and (iii) the value relevance of disclosure, for these three groups of firms. Hypothesis 3 is therefore to be tested by a model with 3 extensions:

- i) Model 3.0 tests the differences in the levels of CG disclosure;
- ii) Model 3.1 tests the differences in the level of Tobin's  $q$ ; and
- iii) Model 3.2 tests the strength of value relevance of disclosure.

Model 3.2 is to be further subdivided into two versions. Model 3.2a for comparing LargeCap firms with MidCap firms and SmallCap firms; whereas Model 3.2b is used to compare the SmallCap firms with the other two types of firms with an interaction variable  $CG \cdot DV\_S$  (see section 10.7.3 below). If the ANOVA test results show that there is no significant difference between the three groups of firms, then the hypothesis can be rejected. However, if the ANOVA results show evidence that there may be significant differences amongst the groups, a further *post hoc* test is conducted which can reveal which pair(s) of firm groups is different from the other, while keeping the overall significance level for the group-wise test unaltered at 0.05 level. The results of the tests are reported in the following subsections.

### 10.7.1 Testing systematic differences in CG disclosure in Model 3.0

Model 3.0 sets out to test hypothesis H3a, which is re-stated from Section 8.8.5 of Chapter 8 as follows:

#### Hypothesis H3a

**H3a:** There are systematic differences in the voluntary CG disclosure of LargeCap firms, MidCap firms, and SmallCap firms.

To specify the functional form of Model 3.0, a null hypothesis  $H_0$  can be set up which states that the mean CGDscore of all 3 groups are equal, and the alternate hypothesis that states otherwise:

#### Model 3.0

Testing the mean of CGDscores of 3 types of firms with the null hypothesis:

$$\begin{aligned} H_0: CG_L &= CG_M = CG_S \\ H_1: \text{At least one of them is different} \end{aligned} \quad (\text{Model 3.0})$$

where  $CG_L$  is the mean CGD Score of LargeCap firms,  $CG_M$  is the mean CGD Score of MidCap firms, and  $CG_S$  is the mean CGD Score of SmallCap firms. The results are shown in Table 10.11.

**Table 10.11 ANOVA single factor test of mean CGDscore for LargeCap, MidCap, and SmallCap firms**

Summary							
Groups	Count	Sum	Average	Variance			
CGDscore L	36	1461.697	40.603	313.459			
CGDscore M	82	3758.298	45.833	596.608			
CGDscore S	140	5606.742	40.048	421.993			
ANOVA							
Source of Variation		SS	df	MS	F	P-value	F crit
Between Groups		1807.991	2	903.996	1.954	0.144	3.031
Within Groups		117953.442	255	462.563			
Total		119761.434	257				

#### 10.7.1.1 Result implications of Model 3.0

The results of the ANOVA test in Table 10.11 show that the  $F$  statistic is 1.954 and has a  $p$ -value 0.144 which is not significant at the 0.05 level. Therefore, in Model 3.0, the null hypothesis  $H_0$ :  $CG_L = CG_M = CG_S$  cannot be rejected. Over the 3-year study period, there may be differences in the mean CGDscores for the LargeCap firms, MidCap firms, and SmallCap firms; but their differences are not significantly different from one another at a group-wise 0.05 level. Therefore, there is no evidence of systematic difference amongst the three groups of firms (i.e., LargeCap, MidCap, and SmallCap) in terms of their overall CGDscores during the 3-year period. The differences in their CGDscore, if any, are not due to their market capitalization.

### **10.7.2 Testing systematic differences in market valuation with Model 3.1**

Model 3.1 sets out to test Hypothesis **H3b**, which is re-stated from Chapter 8 as follows:

#### Hypothesis H3b

**H3b**: There are systematic differences in the market valuation as proxied by  $q$  amongst the LargeCap, MidCap, and SmallCap firms.

In this test, the  $q$  is not winsorized. ANOVA test is used to test the null hypothesis, which is stated together with the alternative hypothesis for a two-tailed test, subject to the degree of freedom offered by the sample size of LargeCap, MidCap, and SmallCap firms, as follows:

#### Model 3.1a

$$H_0: Q_L - Q_M = 0$$

$$H_1: Q_L - Q_M \neq 0$$

(Model 3.1a)



Model 3.1b

$$H_0: Q_L - Q_S = 0$$

$$H_1: Q_L - Q_S \neq 0$$

(Model 3.1b)

Model 3.1c

$$H_0: Q_M - Q_S = 0$$

$$H_1: Q_M - Q_S \neq 0$$

(Model 3.1c)

where  $Q_L$  is the mean  $q$  of L firms (sample size = 36),  $Q_M$  is the mean  $q$  of M firms (sample size = 82), and  $Q_S$  is the mean  $q$  of S firms (sample size = 140). Results of the ANOVA test are shown in Table 10.12.

Since the sample size changes in the years of study, the above-mentioned ANOVA test is applied across different groupings of firms on a year-by-year basis to see if there are any significant differences between the LargeCap, MidCap, and SmallCap firms.

**Table 10.12 ANOVA single factor test of mean  $q$  of LargeCap, MidCap, and SmallCap firms, 2003-2005**

Summary							
Groups	Count	Sum	Average	Variance			
$Q_L$	36	50.258	1.396	0.587			
$Q_M$	82	157.982	1.949	2.362			
$Q_S$	140	198.964	1.421	0.920			
ANOVA							
Source of Variation		SS	df	MS	F	P-value	F crit
Between Groups		15.925	2	7.963	5.977	0.003	3.031
Within Groups		339.695	255	1.332			
Total		355.620	257				

The ANOVA test shows that the  $F$  statistic has a  $p$ -value 0.003 which is significant at 0.05 level. A further test, the Tukey-Kramer test of ANOVA<sup>6</sup>, is carried out to identify which pair(s) of firms show a significant difference in their mean  $q$ 's. The results are shown in Table 10.13.

<sup>6</sup> Tukey-Kramer Test is one of the *post hoc* tests that is applied to compare all different combinations of groups. It is similar to performing a  $t$ -test on each pair of groups but it controls for the familywise error by correcting the level of significance for each test such that the overall type I error rate ( $\alpha$ ) across all comparisons remains at 0.05 (see Field (2000), p. 274).

**Table 10.13 Tukey-Kramer Test of mean  $q$  of LargeCap, MidCap, and SmallCap firms, 2003-2005**

Summary							
Level of sig.			0.05				
Numerator d.f.			3				
Denominator d.f.			255				
MSW			1.332				
Q Statistic			3.31				
Tukey-Kramer Test							
Group	Sample Mean	Sample Size	Comparison	Abs. Diff.	S.E. of Diff.	Crit. Range	Results
$Q_L$	1.396	36	$Q_L$ to $Q_M$	0.531	0.145	0.482	<b>Means are different</b>
$Q_M$	1.949	82	$Q_L$ to $Q_S$	0.025	0.136	0.451	Means are not different
$Q_S$	1.421	140	$Q_M$ to $Q_S$	0.555	0.102	0.336	<b>Means are different</b>

The Tukey-Kramer Test results in Table 10.10 show that, in terms of the mean  $q$  over the 3-year study period, there is a difference between the LargeCap firms and the MidCap firms, which is statistically significant (the absolute difference, 0.531, is larger than the critical range 0.482). Similarly, a statistically significant difference is found between the MidCap firms and the SmallCap firms. However, the difference between LargeCap firms and SmallCap firms are not significantly different. The empirical results suggest that market valuation of MidCap firms is quite different from that of LargeCap firms or SmallCap firms. This is consistent with the findings in the pair-wise  $t$ -tests between different types of firms with respect to  $q$  on year-to-year basis (as shown in Table 9.11 in Chapter 9).

#### 10.7.2.1 Result implications of Model 3.1

The ANOVA test results as reported in Table 10.12 indicate a very small  $p$ -value (0.003) for Model 3.1, which is highly significant at 0.05 level. After conducting the Tukey-Kramer test, it is found that that there are systematic differences amongst LargeCap, MidCap, and SmallCap firms in terms of  $q$  over the 3-year study (as shown in Table 10.13). Hence, Hypothesis **H3b**, that postulates systematic differences in the market valuation (proxied by Tobin's  $q$ ) amongst LargeCap, MidCap, and SmallCap firms in the sample, cannot be rejected.

### 10.7.3 Testing value relevance of CG disclosure for SmallCap firms relative to other firms in Model 3.2a and Model 3.2b

As mentioned earlier in Section 10.7, Model 3.2 has two versions, Models 3.2a and 3.2b, which are set out to test the third aspect of Hypothesis 3. H3 is related to the *strength* of the relationship between CG disclosure and firm valuation for various firms. It is hypothesized that, due to the differences in firms by market capitalization, the strength of the relationship between CG disclosure and firm valuation may differ across LargeCap, MidCap, and SmallCap firms. Hence, it calls for a test to ascertain as to whether the strength differs systematically amongst them. As discussed in Section 8.8.5 in Chapter 8, the following three sub-hypotheses are postulated:

**H3c:** There are systematic differences in the strength of relationship between voluntary CG disclosure and firm valuation of LargeCap firms and MidCap firms.

**H3d:** There are systematic differences in the strength of relationship between voluntary CG disclosure and firm valuation of MidCap firms and SmallCap firms.

**H3e:** There are systematic differences in the strength of relationship between voluntary CG disclosure and firm valuation of LargeCap firms and SmallCap firms.

To test the systematic differences amongst the sample firms, an incremental-difference approach is used to test the above hypotheses (discussed in Section 8.8.5 of Chapter 8). Firstly, three dummy variables, DV\_L, DV\_M, and DV\_S, are assigned as identifiers to each firm of the LargeCap-, MidCap-, and SmallCap sample respectively. A value '1' is assigned to the dummy variable if the firm belongs to its respective group, and '0' if otherwise. Then the CGDscore of each sample firm is multiplied by the value of its respective dummy variable to form three sets of interaction variables: CG\*DV\_L for LargeCap firms, CG\*DV\_M for MidCap firms, and CG\*DV\_S for SmallCap firms accordingly. These three sets of interaction variables demonstrate the *joint* outcome of market capitalization and the CGDscore for each sample firm. Compared to a pre-selected group of firms (the base group), a sample firm is considered to have a systematic difference from the base group if its joint outcome shows a statistically significant difference from that of the base group.

To test whether there are systematic differences in the *value relevance* of voluntary disclosure of firms, a regression model is specified using  $Wq$  (i.e., winsorized  $q$  at 5% and 95%) as the dependent variable, and using the joint outcome of market capitalization and

CGDscore as explanatory variable, controlling for other firm characteristics. Selected LargeCap firms as the base group for comparison, two dummy variables (DV\_M and DV\_S) and two interaction variables (CG\*DV\_M and CG\*DV\_S) are included as explanatory variables in the regression model. The coefficients of DV\_M and DV\_S thus estimated from the model shall reflect the differences from the Intercept (i.e., 0, which represents the coefficient of the base group DV\_L); thus the significance of their differences with respect to the base group (i.e., DV\_L) can be tested. Similarly, the coefficients of the interaction variables (i.e., CG\*DV\_M and CG\*DV\_S) thus estimated will indicate the difference in the slope of the regression function for the MidCap and SmallCap firms as compared to the LargeCap firms. A *t*-test on these coefficients will indicate whether there are systematic differences across firms of different market capitalization groups in terms of the value relevance of their voluntary disclosure.

Model 3.2a is therefore set up to test the value relevance of the joint disclosure with market capitalization for MidCap firms relative to LargeCap firms, and that of SmallCap firms relative to LargeCap firms whilst controlling for CG practices variables and company characteristics variables. The model is given by the condensed functional form as follows:

Model 3.2a

$$Wq_{i,t} = \beta_0 + \beta_1 CGscore_{i,t} + \beta_2 \Sigma CGprac_{i,t} + \beta_3 \Sigma ComChar_{i,t} + \beta_4 DV\_M_{i,t} + \beta_5 DV\_S_{i,t} + \beta_6 CG*DV\_M_{i,t} + \beta_7 CG*DV\_S_{i,t} + \varepsilon_{i,t} \quad (\text{Model 3.2a})$$

where:

$Wq$ , CGDscore, CGprac, ComChar, DV\_M, DV\_S, CG\*DV\_M, and CG\*DV\_S are as previously defined;  $\beta_0$  is the intercept,  $\beta_1, \beta_4, \beta_5, \beta_6$ , and  $\beta_7$  are parameter estimates;  $\beta_2, \beta_3$  are vectors;  $\varepsilon_t$  is the error term; subscript *i* denotes the firm *i* where  $i = 1, 2, 3, \dots, n$ ; subscript *t* denotes fiscal year where  $t = 1, 2, 3$ .

While Model 3.2a compares MidCap firms and SmallCap firms individually to LargeCap firms, Model 3.2b is used to test the value relevance of CGD Score for the SmallCap firms relative to the combined group of LargeCap and MidCap (L+M) firms. The dummy variables for the combined L+M firms are therefore set as zero. Hence, Model 3.2b has the condensed functional form as follows:

Model 3.2b

$$Wq_{i,t} = \beta_0 + \beta_1 CGscore_{i,t} + \beta_2 \Sigma CGprac_{i,t} + \beta_3 \Sigma ComChar_{i,t} + \beta_4 DV\_S_{i,t} + \beta_5 CG*DV\_S_{i,t} + \varepsilon_{i,t} \quad (\text{Model 3.2b})$$

where:

$Wq$ , CGDscore, CGprac, ComChar, DV\_M, DV\_S, CG\*DV\_M, and CG\*DV\_S are as previously defined;  $\beta_0$  is the intercept,  $\beta_1$ ,  $\beta_4$ , and  $\beta_5$ , are parameter estimates;  $\beta_2$ ,  $\beta_3$  are vectors;  $\varepsilon_i$  is the error term; subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3, \dots, n$ ; subscript  $t$  denotes fiscal year where  $t = 1, 2, 3$ . Results of the Model 3.2a and Model 3.2b are shown in Table 10.14 on the next page.

From Table 10.14, it can be seen that the results for both Model 3.2a (column 2) and Model 3.2b (column 3) are very similar. Both models indicate that the dummy variables for the SmallCap firms (DV\_S) have negative coefficients and are highly significant at 0.01 level. In Model 3.2a, the coefficient on DV\_S is -2.001 (row 18, column 2), suggesting that SmallCap firms have a lower mean  $q$  than that of the base group (LargeCap firms). However, the *joint* variable CG\*DV\_S (row 20, column 2) is not significant. It implies that there is no systematic difference that is statistically significant in the *strength* of value relevance of CG disclosure, between SmallCap and LargeCap firms. Also, the joint variable CG\*DV\_M in Model 3.2a has an insignificant coefficient (row 19, column 2), indicating that the strength of the relationship for MidCap firms is not significantly different from that for the base group of LargeCap firms, thus affirming that the value relevance model can be equally applied to LargeCap firms, MidCap firms, and SmallCap firms alike.

Company Characteristics variables (ComChar variables), comprised of Return on Equity (ROE), Sales Income (LnSales), Equity of the firm (LnEqty), and Debt/Asset ratio (Debt/TA), continue to be significant variables that affect a firm's market value ( $Wq$ ). This is consistent with the findings from previous models that a firm's market valuation is primarily driven by its financial performance and capital structure ( $R^2$  is about 0.47, meaning 47% of the variations of the dependent variable  $Wq$  can be explained by the variations of the explanatory variables in both models).

**Table 10.14 Test results of value relevancy of the joint CG disclosure and market capitalization of firms. Dependent variable =  $Wq$ .**

	1	2	3
1	Model	3.2a	3.2b
2	Firms	L + M + S	L + M + S
3	Observations	258	258
4	Intercept	<b>12.338**</b> (0.0001)	<b>10.388**</b> (0.0001)
5	CGDscore	-0.005 (0.597)	-0.004 (0.326)
6	BoDsize	-0.067 (0.126)	-0.060 (0.168)
7	NumINED	0.061 (0.643)	0.078 (0.550)
8	INED%	-0.013 (0.364)	-0.013 (0.354)
9	Dir%Own	-0.001 (0.660)	-0.001 (0.566)
10	SplitRole	0.161 (0.195)	0.153 (0.220)
11	DualList	0.040 (0.766)	-0.099 (0.445)
12	ROE	<b>0.020**</b> (0.0001)	<b>0.020**</b> (0.0001)
13	LnSales	<b>0.176**</b> (0.002)	<b>0.195**</b> (0.001)
14	W_SalGrow	-0.001 (0.448)	0.000 (0.520)
15	LnEqty	<b>-0.542**</b> (0.0001)	<b>-0.497**</b> (0.0001)
16	Debt/TA	<b>-0.025**</b> (0.0001)	<b>-0.025**</b> (0.0001)
17	DV_M	-0.491 (0.257)	n.a.
18	DV_S	<b>-2.001**</b> (0.0001)	<b>-1.519**</b> (0.0001)
19	CG*DV_M	0.002 (0.812)	n.a.
20	CV*DV_S	0.009 (0.301)	0.008 (0.131)
21	Adj. R <sup>2</sup>	0.472	0.470
22	Significance F	<b>0.0001**</b>	<b>0.0001**</b>

(Notes:  $P$ -values are shown in brackets. Coefficients are bold if  $p$ -values < 0.10; \* if  $p$ -values < 0.05; and \*\* if  $p$ -values < 0.01. Sample size= 258 firms-years from 2003-2005.)

#### 10.7.3.1 Result implications of Model 3.2a and Model 3.2b

For Model 3.2a, firms that belong to the SmallCap category have a significantly lower  $q$  than those belong to the LargeCap and MidCap category. The interaction variables of CG\*DV\_M and CG\*DV\_S are not significant (Table 10.14, rows 19 and 20, column 2).

The results indicate that the slopes of the CG–and-market capitalization interaction variables for MidCap firms and SmallCap firms are not significantly different from the slope for LargeCap firms. Hence, there is no evidence to suggest that the value relevance of CGDscore differs amongst the 3 market capitalization groups of firms. Hypothesis **H3c**, that there are systematic differences in the strength of relationship between voluntary CG disclosure and market value ( $Wq$ ) among LargeCap, MidCap, and SmallCap firms, is not supported.

For Model 3.2b, amongst all the dummy variables, only the DV\_S is significant, but negative (Table 10.14, row 18, column 3). The interaction variable CG\*DV\_S is not significant. This is in comparison with the dummy variable DV\_L+M and CG\*DV\_L+M, which are selected as the base categories. There is no evidence to support that the strength of value relevance of CG disclosure for S firms differs from the combined L+M firms. Hence, hypothesis **H3c**, that there are systematic differences in the strength of relationship between voluntary CG disclosure and market valuation ( $Wq$ ) among LargeCap, MidCap, and SmallCap firms, is not supported.

Because the interactive terms in Model 3.2a (namely, CG\*DV\_M and CG\*DV\_S) are not statistically significant, implying that the value relevancy of the CG disclosure has no statistical differences between LargeCap, MidCap, and SmallCap firms, a further robustness test based on the simple regression model using CGDscore (Model 1.0) is re-estimated with the inclusion of these dummy variables DV\_M, DV\_S and the dummy joint variables CG\*DV\_M and CG\*DV\_S. No other CGprac variables or ComChar variables are included. The test results are shown in Table 10.15.

**Table 10.15 Test results of value relevancy of the joint CG disclosure and market capitalization of firms using basic model. Dependent variable =  $Wq$ .**

	1	2	3
1	Model	3.2c	3.2d
2	Firms	L+M+S	L+M+S
3	Observations	258	258
4	Intercept	<b>1.587**</b> (0.001)	<b>1.659**</b> (0.0001)
5	CGDscore	-0.005 (0.654)	0.002 (0.598)
6	DV_M	0.221 (0.678)	n.a.
7	CG*DV_M	0.007 (0.530)	n.a.
8	DV_S	-0.406 (0.423)	-0.478 (0.117)
9	CG*DV_S	0.011 (0.318)	0.004 (0.501)
10	Adj. R2	0.033	0.018
11	Significance F	<b>0.019*</b>	<b>0.057</b>

The outcome of Model 3.2c represents the test on the differential impact of CGDscore on  $Wq$  for the MidCap firms and for the SmallCap firms relative to LargeCap firms. The two interactive terms, CG\*DV\_M (Table 10.15, row 7, column 2) and CG\*DV\_S (row 9, column 2) are not statistically significant. Similar results are observed for the intercept and coefficients for Model 3.2d. In sum, they are consistent with the results in the previous Models 3.2a and 3.2b as shown in Table 10.14. Therefore, it can be concluded that the joint product of CG disclosure *and* market capitalization shows no statistical difference in explaining the market valuation of the firm.

In conclusion, SmallCap firms have a distinctive market valuation  $q$ , which is significantly affected by their voluntary CG disclosure (as shown in the simple regression model, Model 1.0\_S in Table 10.1). However, the joint product of CG disclosure and market capitalization shows no differentiation power in distinguishing SmallCap firms from LargeCap firms, suggesting no statistical difference in the value relevancy of their CG disclosure. Therefore, the fact that SmallCap firms are different in terms of the impact of CGDscore on  $q$  may be attributable to some other characteristics that are specific to SmallCap firms but are *not* able to be reflected by the firms' market capitalization. Information asymmetry faced by SmallCap firms, for instance, may be one of those candidates of characteristic that would be distinctly affecting the market valuation of a firm.



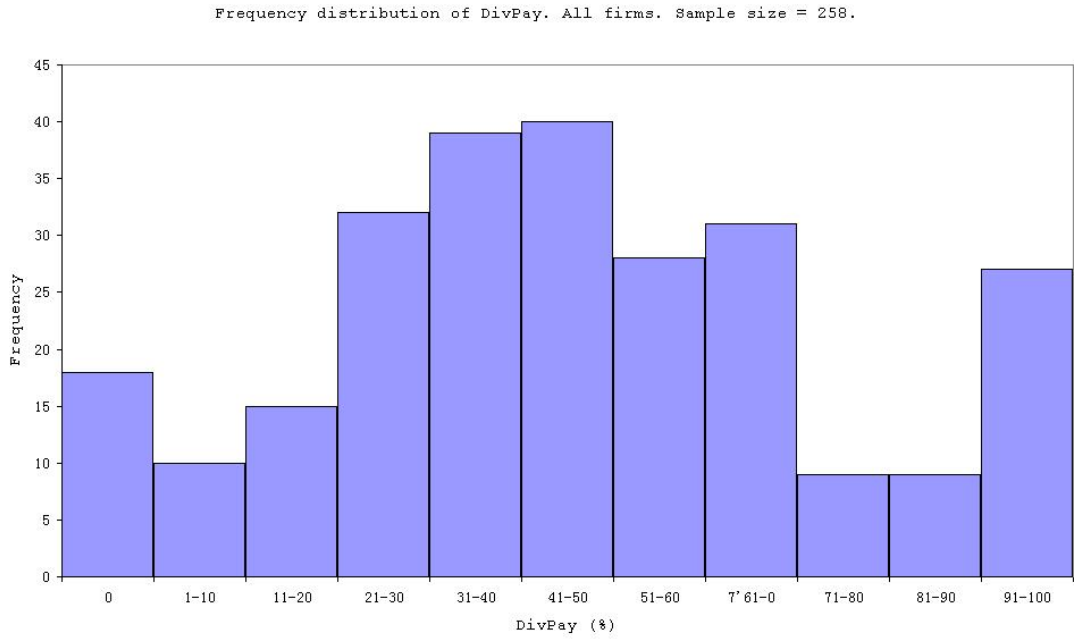
Taking these findings together, the evidence suggests that voluntary CG disclosure level (from Model 3.0 above), and the value relevancy of the voluntary CG disclosure (from Models 3.2a - 3.2d), exhibit no systematic differences for LargeCap, MidCap, or SmallCap firms during the study period. Therefore, combining LargeCap and MidCap firms into a merged L+M sample will not be expected to average out their essential characteristics (hence distort results of the regression models) but pooling LargeCap, MidCap, and SmallCap firms into an L+M+S sample may run the risk of averaging out the distinctiveness of SmallCap firms. To further ascertain the distinctiveness of SmallCap firms, a robustness test has been conducted using a non-parametric test, Rank Regression. The results of Rank Regression give the similar outcome as the Ordinary Least Square Regression. The results obtained in Models 3.2a and 3.2b, therefore, appear to be robust (see Section 10.10.3).

## 10.8 Testing the effect of CG disclosure on dividend payout

Hypothesis 4 ( $H_4$ ) is set on the relationship between the dividend payout (DivPay) and the CG disclosure of a firm, which is tested with Model 4.0. Dividend Payout ratio (DivPay) becomes the dependent variable in the model.

As previously defined in Section 7.2.2 of Chapter 7, Dividend Payout ratio (DivPay) is defined as the dividend per share (DPS) divided by earnings per share (EPS) expressed in percentage. By default, if there is a very small denominator, e.g., an EPS close to zero or a negative EPS, the value of dividend payout can be affected unduly. For the purpose of analysis in this study, where DPS is paid in excess of EPS, the dividend payout ratio is capped at 100%. Where dividends are paid despite the fact that the firm suffers a loss, i.e. a negative EPS, the DivPay is assigned with the value of 100%. After applying this adjustment to the data, maximum DivPay is capped at 100%, with range of 0 – 100%. The frequency distribution of dividend payout for all firms in the study period is shown in Figure 10.4. It suggests a symmetrical distribution with DivPay for most firms, clustering around 31-50%.

**Figure 10.4 Frequency distribution of Dividend Payout for Pooled Sample**



Model 4.0 is set up to test Hypothesis 4 ( $H4$ ), which is quoted from Section 8.8.6 of Chapter 8 as follows:

Hypothesis 4

$H4$ : Under a strong legal protection regime, high corporate governance ranking firms have lower dividend payout ratios, *ceteris paribus*, than low corporate governance ranking firms.

Following the sequence of discussion of models in Chapter 8, three preliminary models are set up to test the relationship between DivPay and the CG disclosure, CG practices, and firm performances for the three samples, namely, the L+M+S sample, the L+M sample, and the S sample. Dividend payout (DivPay) is regressed on CGDscore, CG Practices variables (CGprac) and Company Characteristics variables (ComChar). The functional form of Model 4.0 is as follows:

Model 4.0

$$DivPay_{i,t} = \beta_0 + \beta_1 CGscore_{i,t} + \beta_2 \Sigma CGprac_{i,t} + \beta_3 \Sigma ComChar_{i,t} + \varepsilon_{i,t} \quad (\text{Model 4.0})$$

Where DivPay, CGDscore, CGprac are as previously defined;  $\beta_0$  is the intercept,  $\beta_1$  is the parameter estimate;  $\beta_2, \beta_3$  are vectors;  $\varepsilon_t$  is the error term; subscript  $i$  denotes the firm  $i$  where  $i = 1, 2, 3, \dots, n$ ; subscript  $t$  denotes fiscal year where  $t = 1, 2, 3$ .

As discussed in Chapter 8, Model 4.0 will be applied to the similar groupings of sample firms as in the testing of Hypothesis 1, namely, the pooled L+M+S sample of all firms, the combined L+M sample of LargeCap and MidCap firms, and the S sample of Small firms.

Hence, Model 4.0 has three extended models: (i) Model 4.0\_LMS for the pooled L+M+S sample; (ii) Model 4.0\_LM for the combined L+M sample, and (iii) Model 4.0\_S for the S sample. Results of the regressions of all three models are presented in Table 10.16 on the following page.

All three models are significant with F values less than 0.0001 (Table 10.16, row 18). In the L+M+S sample (column 2, Model 4.0\_LMS), Board Size (row 6, column 2) and Director Ownership (row 9, column 2) are the significant CG Practices variables that affect the Dividend Payout ratio. The same variables are also found to be significant for the L+M sample. However, they are not significant for the S sample (rows 6 and 9, column 4).

For the L+M sample, results of Model 4.0\_LM indicate that the number of INEDs and the level of directors' ownership are significant factors that would negatively affect Dividend Payout (Table 10.16, rows 7 and 9, column 3). It seems to suggest that the higher the level of insiders' ownership and the more the INEDs on the board, the lower the dividend payout it will be for the firm.

SmallCap firms seem to be different in terms of the relationship between their Dividend Payout ratio and their CG practices. None of the CG Practices variables are significant at any reasonable level (Table 10.16, rows 5 – 11, column 4). Meanwhile, the Company Characteristics variables that are significantly related to Dividend Payout are similar to firms in the L+M+S sample or in the L+M sample. The coefficient of the intercept (row 4, column 4) in Model 4.0\_S is highly significant at the 0.01 level, suggesting that some explanatory variables may be missing from the model.

All in all, the evidence from Model 4.0 and its extended versions indicate that, for SmallCap firms, the Dividend Payout is affected by factors that are different from those for the LargeCap and MidCap firms combined, or from those for a pooled sample composed of firms mixed with different market capitalization. Hence, it is more appropriate to single out SmallCap firms for analysis.

Another observation from the results of the models in Table 10.16 is that the CG disclosure, does not seem to have any significant impact on DivPay of the firms for all samples. This

seems to be at odds with La Porta *et al*'s (2000b) conjecture, which posits that dividends have a monitoring role to play and are expected to be related to the state of a firm's CG. Since the main channel of information about a firm's CG is through the voluntary disclosure, by the management, in the firm's annual reports, the CGDscore should be able to reflect – at least partially – some association with DivPay. An exploration of any potential *joint* effect of CG ranking and insiders' ownership appears to be worthwhile. This will be tested by Model 4.1 as specified in Chapter 8 and the empirical results will be further discussed in Section 10.9 of this Chapter.

**Table 10.16 Results of Dividend Payout regressed on CGDscore, CG Practices variables and Company Characteristics variables for the three samples. Dependent variable = DivPay.**

	1	2	3	4
1	Model	4.0_LMS	4.0_LM	4.0_S
2	Sample	L+M+S	L+M	S
3	Observations	258	118	140
4	Intercept	48.471 (0.214)	<b>129.378</b> (0.100)	<b>204.590**</b> (0.004)
5	CGDscore	-0.067 (0.424)	-0.141 (0.183)	0.074 (0.542)
6	BoDsize	<b>2.601*</b> (0.042)	<b>4.874*</b> (0.022)	2.631 (0.192)
7	NumINED	-2.596 (0.497)	<b>-13.178</b> (0.046)	-1.302 (0.836)
8	INED%	0.447 (0.287)	<b>1.743*</b> (0.033)	0.082 (0.882)
9	Dir%Own	<b>-0.200**</b> (0.009)	<b>-0.499**</b> (0.001)	-0.113 (0.227)
10	SplitRole	4.912 (0.173)	<b>9.057</b> (0.095)	-4.158 (0.396)
11	DualList	-4.234 (0.271)	-3.212 (0.507)	-6.223 (0.295)
12	ROE	<b>-0.330**</b> (0.004)	<b>-0.703**</b> (0.005)	<b>-0.274*</b> (0.042)
13	LnSales	<b>6.161**</b> (0.0001)	<b>7.264**</b> (0.004)	1.826 (0.461)
14	W_SalGrow	<b>-0.065**</b> (0.004)	-0.058 (0.117)	<b>-0.072**</b> (0.012)
15	LnEqty	<b>-6.593**</b> (0.000)	<b>-11.306**</b> (0.000)	<b>-9.322**</b> (0.001)
16	Debt/TA	<b>-0.259*</b> (0.011)	-0.209 (0.139)	<b>-0.499**</b> (0.001)
17	Adj. R <sup>2</sup>	0.158	0.230	0.216
18	Significance F	<b>0.0001**</b>	<b>0.0001**</b>	<b>0.0001**</b>

(Notes: *P*-values are shown in brackets. Coefficients are bold if *p*-values < 0.10; \* if *p*-values < 0.05; and \*\* if *p*-values < 0.01)

## 10.9 Testing the joint effect of CG rank and directors' ownership on dividend payout

Model 4.1 sets out to test hypothesis H5 that under a strong legal protection regime, high corporate governance ranking firms have lower dividend payout ratios, *ceteris paribus*, than low corporate governance ranking firms. The 2x3 matrix, used previously in Model 1.3 and specifying the CG\_RankOwn Groups namely HL, HM, HP, LL, LM, and LP, is applied to the pooled sample, the sample of LargeCap and MidCap firms combined (L+M), and the sample of SmallCap firms (see Table 10.17 below). Similar to Model 1.3, each CG\_RankOwn Group is assigned with a dummy variable (DV\_HL, DV\_HM, DV\_HP, DV\_LL, DV\_LM, and DV\_LP) accordingly. The regression model for testing H5 is specified as follows:

### Model 4.1

$$\begin{aligned} \text{DivPay}_{i,t} = & \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \sum_{j=1}^k \beta_j \text{CGprac}_{i,t} + \sum_{m=1}^p \beta_m \text{ComChar}_{i,t} \\ & + \beta_2 \text{DV\_HM}_{i,t} + \beta_3 \text{DV\_HP}_{i,t} + \beta_4 \text{DV\_LL}_{i,t} + \beta_5 \text{DV\_LM}_{i,t} \\ & + \beta_6 \text{DV\_LP}_{i,t} + \varepsilon_{i,t} \end{aligned} \quad (\text{Model 4.1})$$

where:

DivPay<sub>*i,t*</sub> is the dividend payout ratio by firm *i* in year *t*; CGDscore<sub>*i,t*</sub>, CGprac<sub>*i,t*</sub>, are as previously defined; DV\_HM<sub>*i,t*</sub>, DV\_HP<sub>*i,t*</sub>, DV\_LL<sub>*i,t*</sub>, DV\_LM<sub>*i,t*</sub>, and DV\_LP<sub>*i,t*</sub> are dummy variables as defined in Model 1.3; ComChar<sub>*i,t*</sub> denotes a set of company characteristic variables consisting of:

ROE<sub>*i,t*</sub> = return on equity;

LnSales<sub>*i,t*</sub> = natural log of a firm's sales;

SalGrow<sub>*i,t*</sub> = Sales growth over previous year;

LnEqty<sub>*i,t*</sub> = natural log of a firm's equity;

Debt/TA<sub>*i,t*</sub> = debt ratio (i.e., Debt/Total Assets) expressed in percentage;

$\beta_0, \beta_1 \dots \beta_6$  are parameter estimates;  $\beta_j, \beta_m$  are vectors;  $\varepsilon_{i,t}$  is the error term; subscript *i* denotes the firm *i* where  $i = 1, 2, 3 \dots, n$ ; subscript *t* denotes fiscal year where  $t = 1, 2, 3$ ; subscript *k* = 1, 2, ..., 5; and subscript *p* = 1, 2, ..., 5.

Before proceeding with the regression analysis, an inspection of the sampling frame of each sample (i.e. L+M+S firms, L+M firms, and S firms) is taken to evaluate if the sample size is adequate for each CG\_RankOwn Group. It is found that for the sample of L+M firms (as shown in Panel B, Table 10.17), there are only 7 firms in the low Director Ownership category. Of these 7 firms, none belongs to the low CG\_Rank class. The small

number of firms in this Low-CG-Rank-Low-Ownership group may pose some restraints on the interpretation of regression results. As discussed earlier, a small sample size may bias the results of a parametric analysis. A non-parametric test (such as the Kruskal-Wallis Rank Test), on the contrary, may overcome the small sample size problem because inferences drawn from non-parametric tests are based on a test statistic whose sampling distribution does not depend on the specific distribution of the population (Gibbons, 1993, p.2).

**Table 10.17 Sampling frame for Model 4.1**

	Dir% Own Group			
CG_Rank	Low (0-25%)	Medium (25-50%)	Predominant (50%+)	Total
Panel A: L+M+S firms (median CG = 34.43)				
High	31	40	58	129
Low	18	44	67	129
<b>Total</b>	<b>49</b>	<b>84</b>	<b>125</b>	<b>258</b>
Panel B: L+M firms (median CG = 42.15)				
High	7	24	28	59
Low	0	23	36	59
<b>Total</b>	<b>7</b>	<b>47</b>	<b>64</b>	<b>118</b>
Panel C: S firms (median CG = 31.68)				
High	24	14	32	70
Low	18	23	29	70
<b>Total</b>	<b>42</b>	<b>37</b>	<b>61</b>	<b>140</b>

A Kruskal-Wallis rank test is applied to the L+M sample (Panel B, Table 10.17) to test whether the CG\_RankOwn groups in each sampling frame are significantly different in terms of their mean dividend payout (DivPay). The null hypothesis of the test is:

$$H_0: D_{HL} = D_{HM} = D_{HP} = D_{LL} = D_{LM} = D_{LP}$$

where  $D_{HL} \dots D_{LP}$  are the mean DivPay of the CG\_RankOwn groups HL...LP, respectively.

The results of the Kruskal-Wallis test are reported in Table 10.18.

**Table 10.18 Kruskal-Wallis Rank Test for differences in DivPay of 5 CG\_RankOwn Groups of firms in the L+M sample. Sample size = 118**

Group	Sample Size	Sum of Ranks	Mean Ranks
HL	7	593.5	84.79
HM	24	1688.0	70.33
HP	28	1141.0	40.75
LM	23	1515.5	65.89
LP	36	2083.0	57.86
Sum of Squared Ranks/Sample Size			435921.7
Sum of Sample Sizes			118
Number of Groups			5
H Test Statistic			15.530
Critical Value			9.488
<i>p</i> -Value			0.004

In Table 10.18, only five CG\_OwnRank groups (i.e., HL, HM, HP, LM, and LP) are tested as the LL group has no entry. The *p*-value for the test statistics is 0.004 which is highly significant at 0.01 level. Hence, the null hypothesis that the mean Dividend Payout is similar for all five CG\_OwnRank groups of the sample L+M firms is rejected.<sup>7</sup>

The Kruskal-Wallis Rank Test is also run on the S sample of SmallCap firms (Panel C, Table 10.17). The results are shown in Table 10.19 below. The *p*-value of the test statistic is 0.021, also significant at the 0.05 level. Therefore, the null hypothesis that the mean Dividend Payout is similar for all 6 CG\_OwnRank groups of the sample of SmallCap firms is rejected. In sum, splitting of sample firms into those different CG\_RankOwn groups seems to be meaningful for both the L+M sample and the S sample.

**Table 10.19 Kruskal-Wallis Rank Test for differences in mean DivPay of 6 CG\_RankOwn Groups of firms in the S sample, sample size = 140**

Group	Sample Size	Sum of Ranks	Mean Ranks
HL	24	2124.5	88.52
HM	14	612.5	43.75
HP	32	2102.0	65.69
LL	18	1420.5	78.92
LM	23	1436.5	62.46
LP	29	2174.0	74.97
Sum of Squared Ranks/Sample Size			717729.5
Sum of Sample Sizes			140
Number of Groups			6
H Test Statistic			13.310
Critical Value			11.070
<i>p</i> -Value			0.021

<sup>7</sup> As a rule of thumb, Kruskal-Wallis Rank Test requests a sample size of no less than 5 per group within each category (see Anderson, Sweeney, Williams, Freeman, and Shoesmith, (2007), p.741). In Panel B the L+M sample, the HL group has 7 firms. The test result therefore may still be valid. To make a robustness check, a similar Kruskal-Wallis Rank Test is run on 4 groups only (i.e., HM, HP, LM, and LP). The H-statistic is 11.82 and the *p*-value is 0.008. Hence, the null hypothesis based on 4 groups is also rejected.

A regression of DivPay on CGprac variables, ComChar variables, and the CG\_RankOwn group variables is undertaken for Models 4.1\_LMS, 4.1\_LM and 4.1\_S respectively. The regression results are presented in Table 10.20.

**Table 10.20: Results of Dividend Payout regressed on CG Practices variables, Company Characteristics variables, and CG\_Rank dummy variables for the 3 samples**

	1	2	3	4
1	Model	4.1_LMS	4.1_LM	4.1_S
2	Sample	L+M+S	L+M	S
3	Observations	258	118	140
4	Intercept	45.555 (0.246)	74.718 (0.354)	<b>207.433*</b> (0.003)
5	BoDsize	<b>2.182</b> (0.088)	<b>5.237*</b> (0.013)	2.318 (0.247)
6	NumINED	-1.764 (0.641)	<b>-15.635*</b> (0.017)	-0.716 (0.910)
7	INED%	0.340 (0.415)	<b>2.101*</b> (0.012)	0.057 (0.918)
8	SplitRole	4.960 (0.166)	<b>11.809*</b> (0.030)	-1.905 (0.679)
9	Dual List	-3.668 (0.339)	-1.609 (0.732)	-4.134 (0.478)
10	ROE	<b>-0.353)</b> (0.002)	<b>-0.800**</b> (0.001)	<b>-0.280*</b> (0.028)
11	LnSales	<b>6.218**</b> (0.0001)	<b>8.178**</b> (0.001)	2.400 (0.320)
12	W_SalGrow%	<b>-0.073**</b> (0.002)	<b>-0.066*</b> (0.076)	<b>-0.083**</b> (0.003)
13	LnEqty	<b>-6.215**</b> (0.0001)	<b>-10.691**</b> (0.0001)	<b>-9.530**</b> (0.001)
14	Debt/TA	<b>-0.244*</b> (0.018)	-0.195 (0.167)	<b>-0.397*</b> (0.010)
15	DV_HM	<b>-15.298*</b> (0.018)	-10.710 (0.313)	<b>-27.885**</b> (0.002)
16	DV_HP	<b>-21.416**</b> (0.0001)	<b>-35.323**</b> (0.001)	<b>-16.785*</b> (0.016)
17	DV_LL	-8.444 (0.285)	n.a.	-7.289 (0.371)
18	DV_LM	<b>-14.499*</b> (0.019)	-14.967 (0.168)	<b>-19.949**</b> (0.008)
19	DV_LP	<b>-11.434</b> (0.051)	<b>-21.757*</b> (0.045)	-9.961 (0.174)
20	Adj. R <sup>2</sup>	0.170	0.255	0.264
21	Significance F	<b>0.0001**</b>	<b>0.0001**</b>	<b>0.0001**</b>

(Notes: *P*-values are shown in brackets. Coefficients are bold if *p*-values < 0.10; \* if *p*-values < 0.05; and \*\* if *p*-values < 0.01)



The results in Table 10.20 show that Model 4.1\_LMS and Model 4.1\_S are similar in terms of the coefficients of their dummy variables of the joint CG rank and Director Ownership groups. Of the coefficients of the five dummy variables for the CG\_RankOwn groups, four of them are common in terms of significance and directions. Furthermore, all coefficients of these variables are all negative. This implies that, when compared to the base group of HL (i.e., High CG\_rank and Low Dir%Own), all other combination groups exhibit a lower Dividend Payout. This result is observed in both samples of L+M+S firms as well as the S firms. The next section, Section 10.9.1, presents a discussion on the empirical findings of Model 4.1\_LMS, followed by Sections 10.9.2 and 10.9.3 on Model 4.1\_LM and Model 4.1\_S, respectively.

### 10.9.1 Result implications of Model 4.1\_LMS

The coefficients for the six CG\_RankOwn groups for the L+M+S sample are extracted from Table 10.20 and re-arranged in Table 10.21 below for comparison purposes.

**Table 10.21: Coefficients of dummy variables of CG\_RankOwn on Dividend Pay for the L+M+S sample. Sample size = 258.**

	Director Ownership (Dir%Own)		
CG rank	Low (0-25%)	Medium (25-50%)	Predominant (50%+)
High	0	<b>-15.298*</b> (0.018)	<b>-21.416**</b> (0.0001)
Low	-8.444 (0.285)	<b>-14.499*</b> (0.019)	<b>-11.434</b> (0.051)

(Notes: *P*-values are shown in brackets. Coefficients are bold if *p*-values < 0.10; \* if *p*-values < 0.05; and \*\* if *p*-values < 0.01)

The results at Table 10.21 show that when the coefficients of all other five CG\_RankOwn groups (i.e., HM, HP, LL, LM, and LP) are compared with that of the base group (HL), the coefficients are negative (i.e., less than zero). The differences are significant except for the Low CG-rank-Low Dir%Own (LL) group. In graphical display, Figure 10.5 below helps to illustrate the significant differences in these joint CG\_RankOwn groups in comparison with the base HL group in terms of their coefficients on DivPay. In Figure 10.5, the pink line segment represents the high CG\_rank groups of sample firms, while the blue line segment represents the low CG\_rank groups for the firms in the L+M+S sample.

**Figure 10.5** Coefficients of CG\_RankOwn dummy variables on dividend payout for the L+M+S sample. Sample Size = 258. Dependent variable = DivPay.

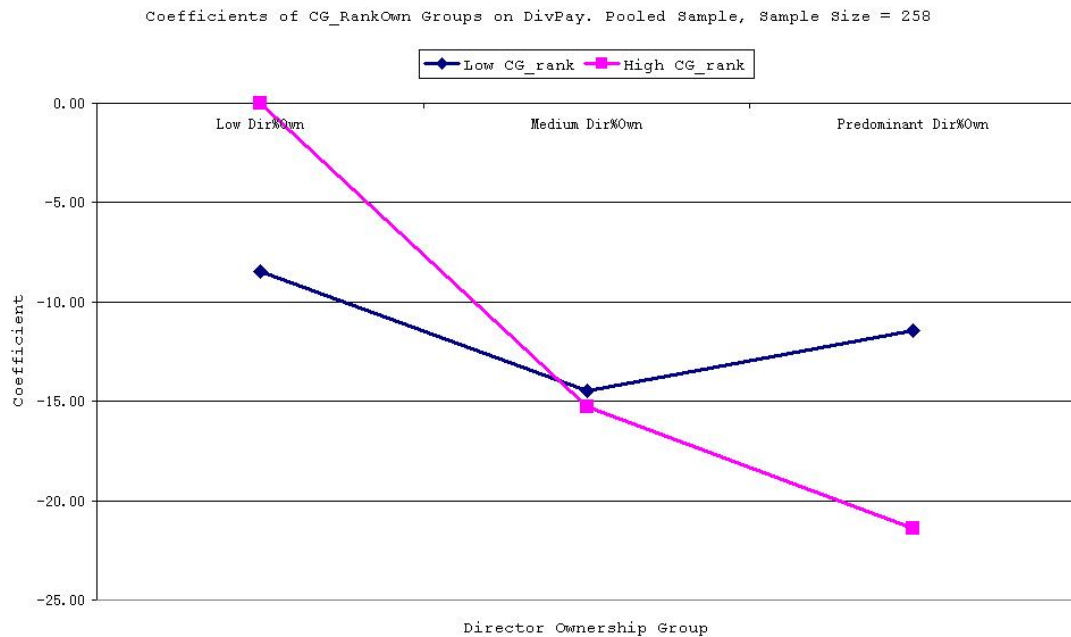


Figure 10.5 offers several interpretations. First, for high CG ranking firms, dividend payout (DivPay) is significantly less than the base group when directors' ownership is at medium level (25%-50%). The DivPay is least, and is highly significant, when directors' ownership reaches the predominant level (>50%). The pattern seems to suggest that, generally speaking, a firm with high CG ranking but characterized with a predominant insider ownership tend to exhibit the lowest level of dividend payout, *ceteris paribus*. The dividend payout level is significantly less than the same for a firm with high CG ranking but low insiders' ownership. This evidence lends support to La Porta *et al*'s (2000b) notion that investors would allow a firm with good CG practices to distribute a lower rate of dividends, under a strong investor legal protection environment.

Second, for low CG ranking firms, a 'V'-shaped pattern is observed with regard to the coefficients of dividend payout. A low CG ranking firm with medium insiders' ownership (25%-50%) tend to have the lowest dividend payout, relative to similar (i.e., low) CG ranking firms with low insiders' ownership (0 – 25%) or predominant insiders' ownership (> 50%). The evidence suggests that, when the firms are not disclosing their CG information as much as others, investors will demand more dividend payout if they suspect agency problems or entrenchment problems to be present within the firm.

A third interpretation of Figure 10.5 is that the coefficient of DivPay for high CG rank firms is always less than that for low CG rank firms, at medium (25%-50%) or predominant (>50%) level of directors' ownership. Furthermore, the difference between the high CG rank and low CG rank firms in terms of their DivPay coefficients is the largest ( $21.416 - 11.434 = 9.982$ ) for the Predominant directors' ownership category. The dividend payout ratios for low CG ranking firms are in sharp contrast with those for high CG ranking firms. Therefore, there is empirical evidence suggesting that a substitution effect may be present between dividend payout and CG ranking for firms with a predominant director's ownership.

To further examine whether higher CG ranking of a firm may substitute for dividend payout, it is necessary to analyze the results of Model 4.1\_LM on the L+M sample and Model 4.1\_S on the S sample. They will be presented in the following sections.

### 10.9.2 Result implications of Model 4.1\_LM

Table 10.22 below shows the coefficients on the dummy variables of the 5 CG\_RankOwn groups for the L+M sample firms. The High-CG\_Rank-Low-Dir%Own (HL) group is the base group, hence has a zero coefficient. The Low-CG\_Rank-Low-Dir%Own (LL) group has no applicable entries. All the rest of the coefficients for the HM, HP, LM, and LP groups have negative coefficients, meaning that all these groups of firms are paying lower DivPay than the base group of HL firms. However, the coefficients for the HM and LM groups (having medium level of director ownership) are statistically insignificant. Only those coefficients for the HP and LP groups are statistically significant.

**Table 10.22 Coefficients of dummy variables of CG\_RankOwn on Dividend Payout for the L+M sample. Sample size = 118.**

CG rank	Director's Ownership (Dir%Own)		
	Low (0-25%)	Medium (25-50%)	Predominant (50%+)
High	0	-10.710 (0.313)	<b>-35.323**</b> (0.001)
Low	n.a.	-14.967 (0.168)	<b>-21.757*</b> (0.045)

(Notes: *P*-values are shown in brackets. Coefficients are bold if *p*-values < 0.10; \* if *p*-values < 0.05; and \*\* if *p*-values < 0.01)

As for Model 4.1\_LM, a chart is used to illustrate the relative positions of dividend payout (DivPay) for the LP and HP groups of the L+M sample firms. The chart is presented at

Figure 10.6 below. The pink line segment denotes the high CG ranking firms. The blue line segment denotes the low CG ranking firms.

**Figure 10.6 Coefficients of CG\_RankOwn dummy variables on dividend payout for the L+M sample. Sample Size = 118. Dependent variable = DivPay.**

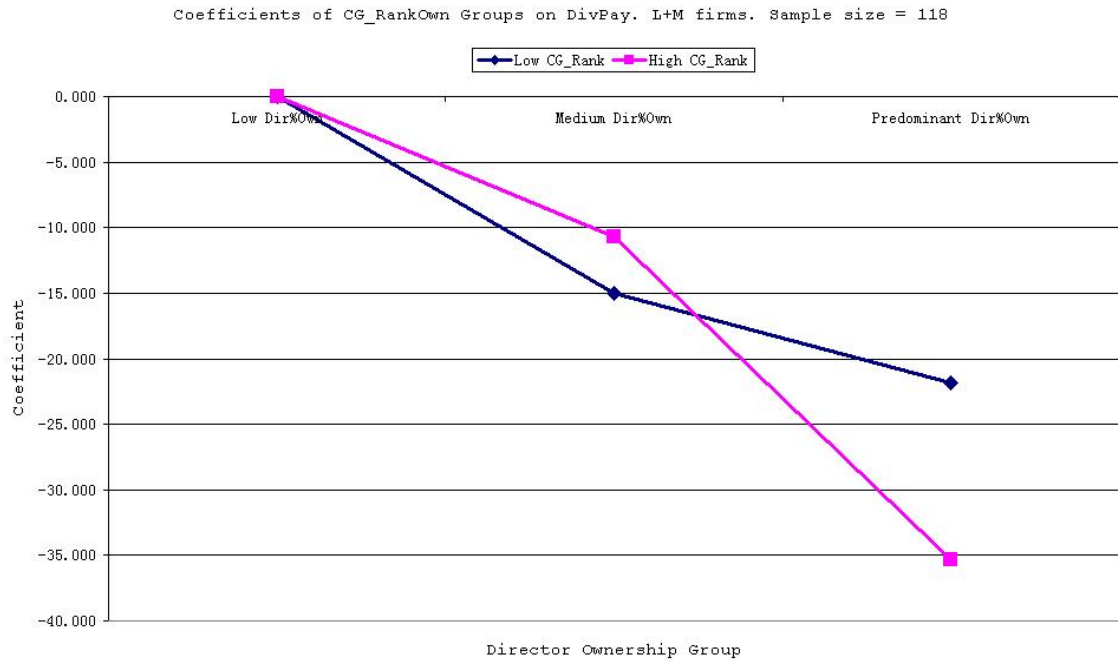


Figure 10.6 shows that, for firms with Predominant director's ownership in the L+M sample, those with high CG rank (i.e. the HP group) are associated with a lower dividend payout than those with low CG rank (i.e., the LP group). Their dividend payout ratios are significantly less than that of the base group (i.e., the HL group). The evidence suggests that the high CG ranking of a firm can act as a substitute for dividend, and that the difference in the coefficients is quite a sizeable one ( $35.323 - 21.757 = 13.566$ ). The implication is that investors can allow a LargeCap or MidCap firm to pay up to 13.57 percent points of Dividend Payout less than its counterpart if it has a high CG disclosure ranking, controlling for the same, predominant, level of directors' ownership. Outsiders seem to have more trust in the management of a firm with higher transparency in its CG disclosure.

### 10.9.3 Result implications of Model 4.1\_S

For the sample of SmallCap firms, the coefficients on the dummy variables for the joint CG\_RankOwn Groups for Model 4.1\_S are extracted from Table 10.20, and tabulated in Table 10.23 as follows:

**Table 10.23: Coefficients of CG\_RankOwn dummy variables on dividend payout (DivPay) for the S sample. Sample size = 140.**

	Director's Ownership (Dir%Own)		
CG rank	Low (0-25%)	Medium (25-50%)	Predominant (50%+)
High	0	<b>-27.885**</b> (0.002)	<b>-16.785*</b> (0.016)
Low	-7.289 (0.371)	<b>-19.949**</b> (0.008)	-9.961 (0.174)

(Notes: *P*-values are shown in brackets. Coefficients are bold if *p*-values < 0.10; \* if *p*-values < 0.05; and \*\* if *p*-values < 0.01)

Unlike the case for the L+M sample, the S sample has sufficient number of firms for each of the CG\_RankOwn Groups (see Table 10.17 Sampling frames), which enables the regression results to be compared for all 5 groups (HM, HP, LL, LM, and LP) against the base HL group of SmallCap firms. The coefficients on the dummy variables of Model 4.1\_S are illustrated in Figure 10.7 below. The pink line segment denotes the High CG rank groups and the blue line segment denotes the Low CG rank groups of SmallCap firms in the S sample. As the coefficients of the LL and LP groups are not significant, there are limitations in interpreting the results pertaining to these two groups of Low CG rank firms.

**Figure 10.7 Coefficients of CG\_RankOwn dummy variables on Dividend Payout for the S sample. Sample Size = 140.**

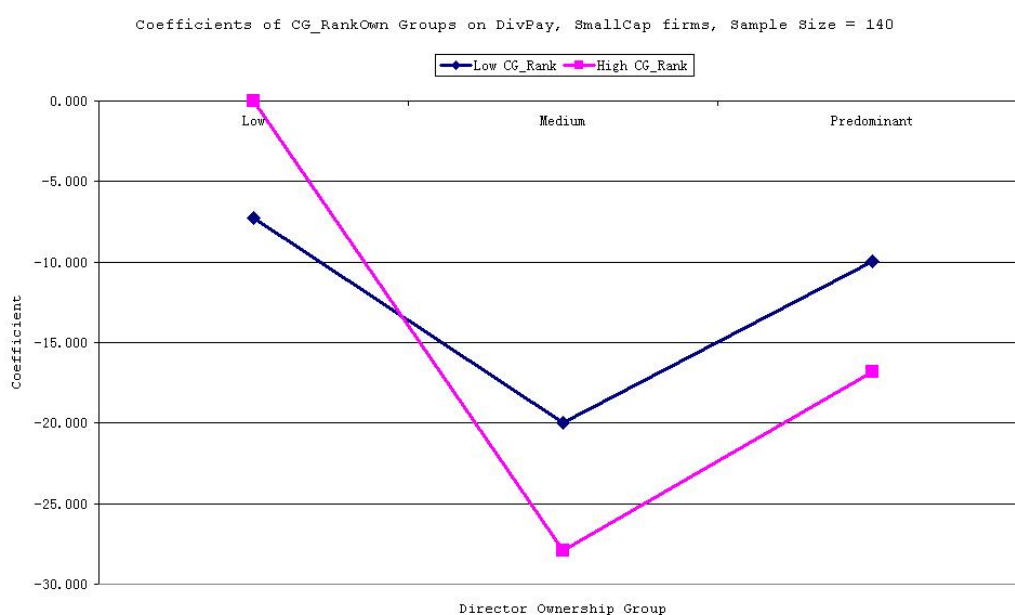


Figure 10.7 illustrates two V-shapes of DivPay coefficients for the High CG rank firms and the Low CG rank firms in the S sample. Both groups of firms have their lowest dividend payout ratios when the firms have the medium level of directors' ownership (25% - 50%).

Compared to the Low CG rank firms, the High CG rank firms have a minimum payout that is even *lower*. Amongst the six groups of SmallCap firms, the High CG\_Rank and Medium Director Ownership group (HM) has the lowest dividend payout, which is the largest difference (27.89 percent points) from that of the base group (HL), and is statistically significant.

The evidence suggests that, whilst SmallCap firms are likely to have agency problems (as reflected by low insiders' ownership of equity 0 - 25%), or susceptible to entrenchment problems (as represented by predominant insiders' ownership > 50%), they will offer *higher* dividend payout ratios relative to firms with a medium insiders' ownership (25% - 50%). Firms that do not succumb to either problem (i.e. with insiders' ownership at 25-50%) can afford to pay a *lower* dividend payout. This V-shape dividend payout pattern applies to both High CG ranking firms and Low CG ranking firms. If the SmallCap firm has a high CG disclosure ranking, it can afford to pay an even *lower* dividend payout ratio than its counterpart with low CG ranking, with similar level of insiders' ownership.

Prior studies have established that a greater information asymmetry normally exists between insiders and outsiders in small firms than in large firms. The findings as presented above give evidence that voluntary disclosure of CG information helps in the reduction of such information asymmetry, to an extent that there appears to be a substitution effect of voluntary CG disclosure for dividend payout. This effect seems to be more pronounced for small firms (as represented by the SmallCap sample firms in this study) than for large firms or medium firms. This substitution effect is present even when the investors are under a strong, legal, investor protection regime such as Hong Kong.

Because the coefficients for firms in the LL and LP categories of CG\_RankOwn groups are not significant, it is not clear whether a V-shape of dividend payout *truly* exists for the Low CG ranking firms. However, the coefficient for the LM group of firms is significant ( $p$ -value = 0.008). It is lower than that for the base group HL, but higher than the HM group. The interpretation of this empirical evidence is that, even for firms that are less succumbing to agency problem or entrenchment problem, a firm with low CG ranking has still to offer a higher dividend payout than its high CG ranking counterpart does. It seems that the market can differentiate high CG ranking firms from low CG ranking firms in its expectation on dividend payout; and that firms of various levels of CG ranking respond by offering different dividend payout ratios accordingly.

#### 10.9.4 Model 5.1 and Model 5.2

Hypothesis 5 (*H5*) as stated in Section 6.3.5 in Chapter 6 postulates that firms with insider ownership of 25% - 50% exhibit the lowest dividend payout ratio. It is re-stated as follows:

##### Hypothesis 5

*H5*: Firms that have insider ownership of 25% - 50% exhibit the lowest dividend payout ratio, compared to firms that have insider ownership of 0-25% or over 50%, *ceteris paribus*.

Correspondingly, two models, Model 5.1 and Model 5.2, have been set up in Chapter 8 to evaluate the coefficients of the dummy variables of the CG\_RankOwn groups. They are re-stated as below:

##### Model 5.1

The coefficient of the dummy variable DV\_HM is less than that of DV\_HL and DV\_HP in Model 4.1.

##### Model 5.2

The coefficient of the dummy variable DV\_LM is less than that of DV\_LL and DV\_LP in Model 4.1.

The empirical results from Model 4.1\_LMS (as shown in column 2 of Table 10.20), and from the summary Table 10.21 that features the coefficients of the dummy variables for firms in the L+M+S sample, provide empirical evidence to support Hypothesis 5. The empirical results from Model 4.1\_S (as shown in column 4 of Table 10.20), and from its corresponding summary Table 10.23 on the S sample of SmallCap firms, also provide empirical evidence to support Hypothesis 5. Only in Model 4.1\_LM where the sample consists of LargeCap and MidCap firms (but with incomplete sample data for regression) is the evidence not in support of such hypothesis.

## 10.10 Robustness Tests

Robustness tests are conducted to ascertain the validity of the results of an empirical test. In this section, the results of some robustness tests on key models in this study are presented and discussed.

### 10.10.1 Robustness test on Model 1.2

Model 1.2 regresses a firm's  $Wq$  on its CGscore, CGprac, and ComChar variables:

$$Wq = \beta_0 + \beta_1 \text{CGDscore}_{i,t} + \beta_2 \Sigma \text{CGprac}_{i,t} + \beta_3 \Sigma \text{ComChar}_{i,t} + \varepsilon_{i,t}, \dots \quad (\text{Model 1.2})$$

where  $Wq$  is the approximation of Tobin's  $q$  as defined in Section 10.2.1 and winsorized at 5% and 95%. CGscore is the firm's score of CG disclosure.  $\Sigma \text{CGprac}$  denotes a set of CG practices variables as mentioned in Section 10.2 above. ComChar denotes a set of company characteristics including return on equity (ROE), the natural log of sales (LnSales), the percentage of sales growth winsorized at 5% and 95% (W\_SalGrow%), the natural log of equity (LnEqty), and the Debt/Asset ratio (Debt/TA).  $\beta_0$  is the intercept;  $\beta_1$ ,  $\beta_2$  are the coefficients of their respective parameters; and  $\varepsilon$  is the error term with  $i = 1, 2, 3 \dots, n$ th firm and  $t$  runs for year 2003, 2004, and 2005 respectively.

Model 1.2 is an extended model of Model 1.1, by including Company Characteristics variables into the regression model. When applied onto the sample of LargeCap and MidCap (L+M) firms, Model 1.2\_LM show that the coefficient on CGDscore is negative (i.e., -0.007), and becomes statistically significant ( $p$ -value = 0.025), which is not the case for Model 1.1\_LM. It suggests that the inclusion of additional variables may have caused such a change of significance. An investigation of robustness is therefore necessary.

### 10.10.2 Possible areas for robustness check on Model 1.2\_LM

Generally, there are four areas where problems may arise that weaken the robustness of a regression model (Gujarati, 1995, p. 319). They are the problems related to:

- (i) heteroscedasticity;
- (ii) multi-collinearity;
- (iii) endogeneity, and
- (iv) autocorrelation.



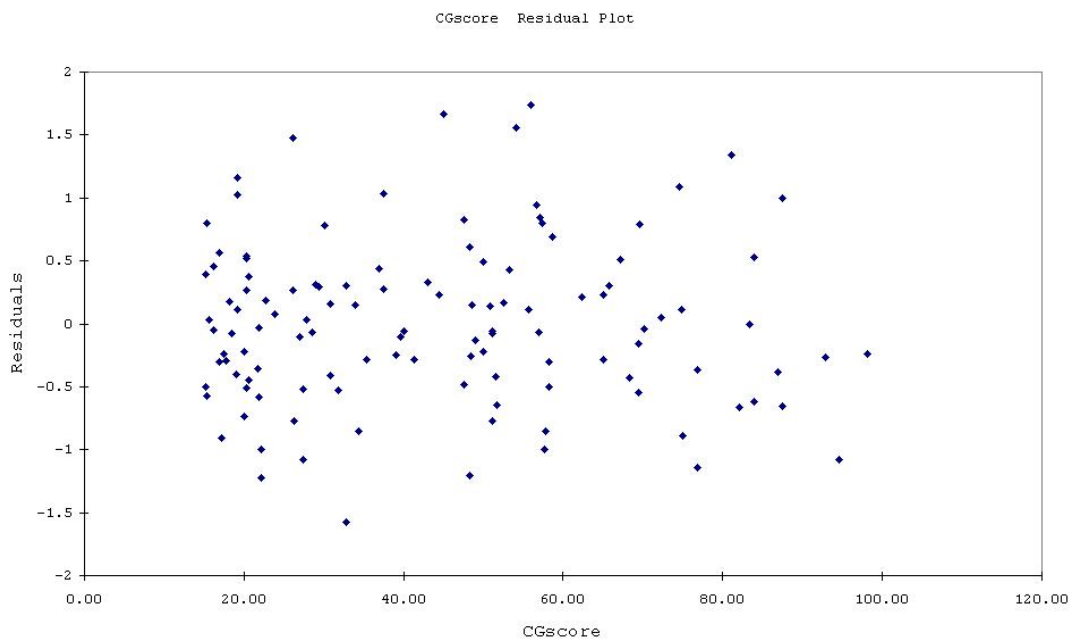
As auto-correlation is mainly concerned with variables with time-series analysis, it is not considered in the robustness test of Model 1.2\_LM in this section.

### 1. Heteroscedasticity problem

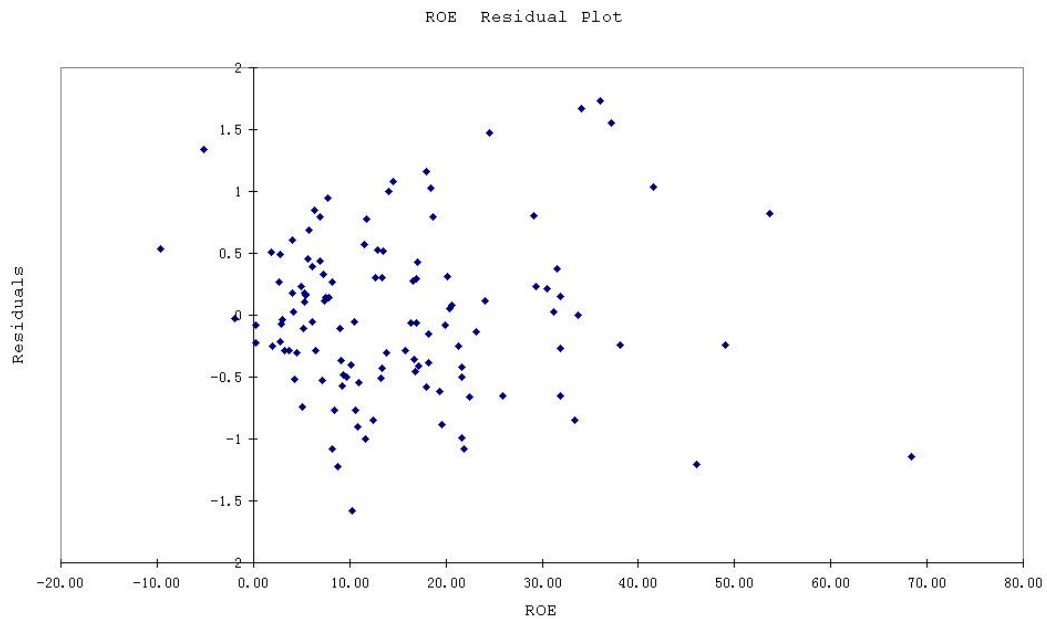
Ordinary Least Squares (OLS) regression models assume that the error terms of the classical linear regression function are homoscedastic, that is, they all have the same variance. To assess whether the error terms are homoscedastic, a residual plot is made on the CGDscore, ROE, and INED%. These variables are chosen because they represent different combinations of attributes that are found in the explanatory variables: CGDscore has a negative coefficient and significant  $p$ -value; ROE has a positive coefficient and significant  $p$ -value; and INED% has a negative coefficient but insignificant  $p$ -value.

The three residual plots for the CGDscore, ROE, and INED% are shown in Figure 10.8 - 10.10 respectively.

**Figure 10.8 Residual plot of CGDscore in Model 1.2\_LM**

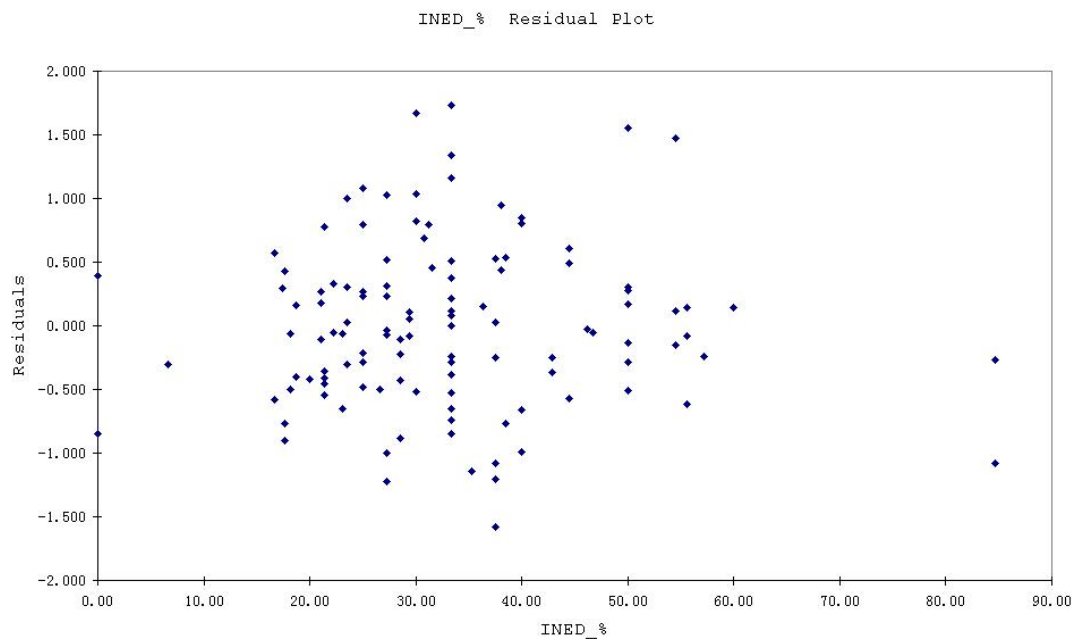


**Figure 10.9 Residual plot of ROE in Model 1.2\_LM**



Comparing the three residual plots of CGDscore, ROE, and INED% of the same model 1.2\_LM, it can be seen that the variability of the residuals increases dramatically as ROE increases (Fig. 10.9), where no similar pattern is detected for CGDscore (Fig. 10.8) or INED% (Fig. 10.10). The funnel-shape of residuals for ROE (Fig. 10.9) illustrates the lack of homogeneity in the variances of the dependent variable  $Wq$  at each level of ROE. The assumption of equal variance of residual (i.e., homoscedasticity) in a classical linear regression model has been violated for the variable ROE.

**Figure 10.10 Residual plot of INED% in Model 1.2\_LM**



## 2. Multi-collinearity problem

Multi-collinearity between predictors makes it difficult to assess the individual importance of a predictor (Field, 2000, p.132). High levels of collinearity among the explanatory variables (i.e., predictors) will result in a high value of  $R^2$ , which inflates the variance of the coefficients of the predictors in the regression model. The result of such high collinearity among the explanatory variables produces high standard errors on the partial regression coefficients. Sometimes, an abnormally high standard error is sufficiently large to cause the calculated t-statistic to be smaller than the critical t-statistic, hence failing to reject the null hypothesis which should have been rejected. High collinearity increases the probability that a good predictor of the outcome will be found non-significant and rejected from the regression model (i.e., a type II error). Accordingly, the regression result may be mistakenly interpreted as showing no relationship between the independent variable and the dependent variable where in fact there is a relationship.

The validity of a multiple regression model may be affected by the presence of high collinearity in 4 ways: (i) the adjusted  $R^2$  size may be limited because an additional predictor may account for little more variance than is the case without it; (ii) it is difficult to delineate each predictor's importance in accounting for the variance of the regression outcome; and (iii) the estimated values of the regression coefficients (i.e., the  $\beta$  values) will be unstable from sample to sample; (iv) the signs of the estimated coefficients can be the opposite of those expected because multi-collinearity affects not only the variances of the ordinary least square (OLS) estimators but the covariances as well. In sum, a high level of collinearity (i.e., imperfect multi-collinearity) among the predictors will diminish the precision of the estimated coefficients, enlarge their standard errors, hence increases uncertainty about the true parameter values (Asteriou and Hall, 2007).

Nevertheless, in reality almost every multiple regression equation will contain some degree of correlation among its explanatory variables (Asteriou and Hall, 2007, p. 88). In accounting data analyses, it is almost inevitable that multi-collinearity exists among the explanatory variables in one form or another. It is therefore not a question to prevent multi-collinearity but a question to identify how serious it is in affecting the statistical relationship under study. Some statisticians suggest deleting one predictor if it has a correlation coefficient value of  $\pm 0.9$  with another predictor. Some researchers suggest  $\pm 0.8$ . For some, the cut-off for high correlation is a value  $\pm 0.6$  (Eastman, 1984).

If  $R = 0.6$  is set to be the threshold for high or low correlation, then it can be seen from Table 10.25 that there are only 3 pairs of explanatory variables for Model 1.2\_LM that have a correlation value larger than 0.6, namely,:

- (i) ROE vs. Wq ( $R = 0.650$ ,  $p\text{-value} = 0.000$ );
- (ii) LnEqty vs. Wq ( $R = 0.612$ ,  $p\text{-value} = 0.000$ ); and
- (iii) INED% vs. NumINED ( $R = 0.729$ ,  $p\text{-value} = 0.000$ ).

As ROE and LnEqty are the control variables in Model 1.2\_LM and they are commonly accepted as the explanatory variables that explain a firm's valuation, they are retained in the Model.

As regards INED% and NumINED, a robustness test is taken: (i) the explanatory variable NumINED is removed from the model and the regression is re-estimated again as Model 1.2\_LM (rev 1), and (ii) both INED% and NumINED are removed from the model and then the regression is re-estimated as Model 1.2\_LM (rev. 2). The purpose of so doing is to compare the original Model 1.2\_LM with the two revised models Model 1.2\_LM (rev 1) and Model 1.2\_LM (rev 2) to see whether other explanatory variables will be significantly changed (in terms of signs and significance).

Regression diagnostics reveal that multi-collinearity could be a problem in the regressions since the NumINED and INED% have a variance inflation factor (VIF) value 25.99 and 26.47 respectively. The variance inflation factor (VIF) is often used as one form of diagnostics to detect whether multi-collinearity is present because it indicates whether an explanatory variable has a strong linear relationship with the other explanatory variables.

Using the variance inflation factor (VIF) to detect multi-collinearity in Model 1.2\_LM, three explanatory variables (BoDSize, NumINED, and INED%) are found to have a VIF value larger than 10 (see Table 10.24). Field (2003) comments that if a VIF has a value greater than 10, then there should be some concern for multi-collinearity. His comments are based on Myers's research<sup>8</sup>. Field also suggests running a correlation matrix of all the explanatory variables to identify any variable which has a correlation of above 0.80 or 0.90, which is a good ball park figure for indication of potential collinearity problem. Table 10.24 presents the VIF values of the explanatory variables in Model 1.2\_LM.

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<sup>8</sup> Myers (1990) suggests a threshold of 10 in the VIF value for multi-collinearity to become a problem.

**Table 10.24 Variance Inflation Factors (VIF) of the explanatory variables for Model 1.2\_LM**

	1	2
1	Variable	VIF
2	CGscore	1.259
3	BoDSize	<b>13.672</b>
4	NumINED	<b>25.985</b>
5	INED%	<b>26.468</b>
6	Dir%Own	1.364
7	SplitRole	1.204
8	DualList	1.263
9	ROE	2.106
10	LnSales	1.706
11	W_SalGrow%	1.119
12	LnEqty	2.449
13	Debt/TA	1.366

It can be seen from Column 2 of Table 10.24 that the VIF of BoDSize, NumINED, and INED% are larger than 10. Each of these 3 explanatory variables may be contributing to each other's variance, as well as the variance of the dependent variable  $Wq$ . Putting all three explanatory variables into the same regression model may therefore make the estimated coefficients uncertain and imprecise (due to a larger standard error of coefficient). It will be difficult to disentangle their separate influences on the dependent variable.

There is no readily made solution to this multi-collinearity problem. Some econometricians (e.g., Field, 2003; Asteriou & Hall, 2007) suggest deleting one or all highly collinear variables from the regression model although they admit there is no established statistical theory to determine which collinear variable(s) to drop. Other econometricians (e.g., Gujarati, 1995) caution that dropping a variable from a model which is theoretically relevant in explaining the relationship may lead to a specification bias problem. Multi-collinearity may not necessarily be bad if the purpose of the regression analysis is prediction, not seeking for reliable estimation of the parameters in the population (Gujarati, 1995, p. 341-345). The general rule of thumb is to delete those correlated variables whose relevant information is already reflected (at least partially if not entirely) in those variables that stay in the regression model.

To determine which variables are correlated to each other, a Pearson correlation analysis is hence carried out amongst those explanatory variables and dependent variable in Model 1.2\_LM for the L+M sample set. The results are presented in Table 10.25. The results indicate that NumINED and INED% are highly correlated with each other (correlation

coefficient  $r = 0.729$ ) but not as critically correlated as Field (2003) has cautioned. Other variables that are highly correlated with  $Wq$  are ROE ( $r = 0.650$ ) and LnEqty ( $r = -0.612$ ). Their  $p$ -values are also statistically significant.

Multi-collinearity is an econometric issue that often arises in corporate governance studies (e.g., Cheng and Courtenay, 2006). Researchers often make efforts to contain its impact on the validity of their analysis rather than eliminate it entirely from their analytical model. When the VIF of some of the explanatory variables approaches ten, or the Pearson Correlation between the problematic variables is high (e.g., approaching 0.8 or above), there is indication of multi-collinearity.

**Table 10.25 Correlation matrix of the variables in Model 1.2\_LM**

	Wq	CGDscore	BoDSize	NumINED	INED%	Dir%Own	Split Role	DualList	ROE	LnSales	W_SalGrow	LnEqty
CGscore	0.041 (0.657)											
BoDSize	<b>-0.270**</b> (0.003)	-0.037 (0.688)										
NumINED	-0.041 (0.662)	<b>0.292**</b> (0.001)	<b>0.305**</b> (0.001)									
INED%	0.154 (0.096)	<b>0.277**</b> (0.002)	<b>-0.397**</b> (0.000)	<b>0.729**</b> (0.000)								
Dir%Own	-0.111 (0.232)	<b>-0.197*</b> (0.032)	-0.007 (0.944)	<b>-0.345**</b> (0.000)	<b>-0.294**</b> (0.001)							
SplitRole	<b>0.184*</b> (0.047)	<b>0.184*</b> (0.046)	0.130 (0.160)	0.161 (0.081)	0.030 (0.744)	<b>-0.185*</b> (0.045)						
DualList	-0.042 (0.651)	-0.014 (0.878)	<b>0.190*</b> (0.039)	-0.006 (0.950)	-0.135 (0.146)	-0.180 (0.051)	-0.088 (0.342)					
ROE	<b>0.650**</b> (0.000)	<b>0.241**</b> (0.009)	-0.176 (0.057)	0.026 (0.778)	0.148 (0.110)	-0.118 (0.204)	0.059 (0.526)	-0.039 (0.674)				
LnSales	0.087 (0.350)	0.129 (0.162)	0.053 (0.565)	0.055 (0.552)	-0.041 (0.661)	0.089 (0.340)	-0.052 (0.574)	<b>0.199*</b> (0.031)	0.163 (0.078)			
W_SalGrow	-0.015 (0.873)	-0.068 (0.466)	-0.169 (0.067)	-0.052 (0.579)	0.056 (0.544)	0.131 (0.158)	0.095 (0.308)	-0.146 (0.116)	0.019 (0.839)	0.099 (0.288)		
LnEqty	<b>-0.612**</b> (0.000)	-0.125 (0.178)	<b>0.361**</b> (0.000)	0.171 (0.064)	-0.105 (0.256)	0.082 (0.378)	-0.125 (0.179)	<b>0.242**</b> (0.008)	<b>-0.599**</b> (0.000)	<b>0.236**</b> (0.010)	-0.009 (0.924)	
Debt/TA	<b>-0.385**</b> (0.000)	0.079 (0.394)	-0.062 (0.503)	-0.155 (0.094)	-0.142 (0.126)	0.085 (0.361)	-0.108 (0.242)	0.136 (0.142)	-0.059 (0.529)	<b>0.385**</b> (0.000)	0.089 (0.340)	0.007 (0.939)

(Cell contents: Pearson correlation. *p*-value in bracket.

\* : *p*-value < 0.05 are bold

\*\* : *p*-value < 0.01 are bold)

Because NumINED and INED% are highly correlated and both of them have a very large VIF, they are deleted from the set of explanatory variables and the regression is re-estimated in Model 1.2\_LM (rev 2). The regression results of such revised models are presented under Column 3 and Column 4 in Table 10.26 (For comparison purposes, the results of the original Model 1.2\_LM are also shown under Column 2 in Table 10.26).

**Table 10.26 *Wq* regressed on CGscore, CGprac variables, and ComChar variables. Definitions of the variables are stated under model 1.2 in Section 10.4.**

	1	2	3	4
1	Model	1.2_LM	1.2_LM(rev 1)	1.2_LM(rev 2)
2	Firms	L+M	L+M	L+M
3	Intercept	<b>7.266*</b> (0.002)	<b>7.268**</b> (0.0001)	<b>7.264**</b> (0.0001)
4	CGscore	<b>-0.007*</b> (0.025)	<b>-0.007*</b> (0.024)	<b>-0.007*</b> (0.030)
5	BoDsize	-0.053 (0.397)	<b>-0.048*</b> (0.020)	<b>-0.048*</b> (0.011)
6	NumINED	0.002 (0.992)	n.a.	n.a.
7	INED%	-0.001 (0.965)	0.000 (0.955)	n.a.
8	Dir%Own	-0.001 (0.890)	0.000 (0.918)	0.000 (0.928)
9	SplitRole	<b>0.385*</b> (0.019)	<b>0.366*</b> (0.020)	<b>0.366*</b> (0.019)
10	DualList	<b>0.327*</b> (0.026)	<b>0.314*</b> (0.027)	<b>0.315*</b> (0.024)
11	ROE	<b>0.027**</b> (0.0001)	<b>0.025**</b> (0.001)	<b>0.025**</b> (0.001)
12	LnSales	<b>0.440**</b> (0.0001)	<b>0.437**</b> (0.0001)	<b>0.437**</b> (0.0001)
13	W_SalGrow	-0.001 (0.421)	-0.001 (0.411)	-0.001 (0.407)
14	LnEqty	<b>-0.605**</b> (0.0001)	<b>-0.607**</b> (0.0001)	<b>-0.608**</b> (0.0001)
15	Debt/TA	<b>-0.039**</b> (0.0001)	<b>-0.038**</b> (0.0001)	<b>-0.038**</b> (0.0001)
16	Adj. R <sup>2</sup>	0.736	0.739	0.741
17	Significance F	<b>0.0001**</b>	<b>0.0001**</b>	<b>0.0001**</b>
18	Observations	118	118	118

(Notes:  $p$ -value < 0.10 are bold.  $p$ -values are shown in brackets; \*\* if  $p$ -value < 0.01; \* if  $p$ -value < 0.05)

From Column 4, Table 10.26, it can be seen that the adjusted R<sup>2</sup> (row 16) does not change drastically, meaning that the revised model does not contribute significant improvement in explaining the level of *Wq* when the correlated variables NumINED and INED% are



removed from the original regression model 1.2\_LM. The board size variable (BoDsize), however, becomes statistically significant at 0.05 level. (A change in significance in the explanatory variable(s) is one of the many symptoms of a multi-collinearity problem.)

Previous research has suggested that board size is associated with significantly lower debt financing costs; and a larger board of directors provides greater monitoring of the financial accounting process (Anderson, Mansi, & Reeb, 2004; Coles, Daniel, and Naveen, 2008). There is reason to expect that board size to be associated with a firm's market valuation and related to the firm's corporate governance. Therefore, it is *economically relevant* to retain the BoDsize variable in the regression model. Furthermore, the objective of this study is to investigate whether a relationship exists between the firm's market valuation and the CG variables; not to estimate the true parameters of the population. Dropping the two most correlated explanatory variables (i.e. NumINED and INED%) and retaining the BoDsize variable are hence adequate to tackle the multi-collinearity problem for this model, while acknowledging the possibility that the Ordinary Least Square (OLS) estimate of the intercept is biased; but the slope coefficient estimates are unaffected (Kennedy, 1992, p. 110).

### 3. Endogeneity problem

It is often argued that studies in CG disclosure and market valuation may suffer from the reverse causation flavour of endogeneity. It is possible for firms with high Tobin's  $q$  to choose good governance practices because this will further enhance their market value (Black, Jang, and Kim, 2006). Gillan, Hartzell, and Starks (2003) test a reverse causation model in which Tobin's  $q$  is an explanatory variable to predict governance for U.S. firms. Durnev and Kim (2005) develop a model in which a firm's choice of CG is endogenously related to investment opportunities, need for external financing, and inside ownership. Himmelberg, Hubbard, and Palia (1999) discuss the possibility of unobserved determinants of Tobin's  $q$  that are also determinants of insider ownership. In that case, insider ownership may spuriously appear to be a determinant of  $q$ .

Standard econometric procedures for addressing endogeneity suggest the use of an instrument variable for the potentially problematic endogenous variable (i.e., the CGDscore in this study). The criteria for an ideal instrumental variable are that it should be exogenous and not be influenced by the dependable variable of interest (i.e., Tobin's  $q$ ); that it should be correlated with CGDscore (to preserve regression power) but should

predict the dependent variable  $q$  only *indirectly* through its effect on CGDscore, not directly (Black, Jang, and Kim, 2006, p. 384). However, such an ideal instrumental variable is difficult, if not impossible, to find (Ittner and Larcker, 2001; Larcker, 2003); and even if it is found, it may be a weak instrument (Borsch-Supan and Koke, 2002). Furthermore, Larcker and Rusticus (2005) show that the instrumental variable estimators are unlikely to be preferred over the OLS estimators as “this solution to the endogeneity problem is worse than the problem itself if the instrument is weak (i.e., low relevance) and endogenous” (Chenhall and Moers, 2007a, p.189). The general conclusion from the discussion by these researchers is that endogeneity can never be entirely solved, and that econometrics cannot solve the problem of endogeneity. Using theory, logic, and common sense to explain the relationships between the variables in the structural model is the best strategy to address the endogeneity issue (Chenhall and Moers, 2007b, p. 219).

In conclusion, Model 1.2\_LM may have violated some the OLS assumptions, to such an extent that the coefficients on the intercepts in the model are biased; but the coefficients of the slope estimates are not affected. For highly correlated explanatory variables that are present in Model 1.2\_LM, removing some of the correlated variables do not significantly change the results of regression models (e.g. Model 1.2\_LM (rev 1) and Model 1.2\_LM (rev 2)) in terms of the signs and p-values of the coefficients. Furthermore, the choice of the explanatory variables that are included in Model 1.2\_LM is explained by theories, which are developed and tested upon by previous researchers. Therefore, it is concluded that the problems of multicollinearity and endogeneity in this model are acknowledged, with maintaining the status quo as the recommended solution.

### **10.10.3 Robustness tests on Model 1.3**

In this section, robustness tests have been conducted for the following purposes:

- (i) to ascertain the outcome of the regression results obtained in Model 1.3 when the effect of CG Practices variables, Company Characteristics variables and the joint effect of CG ranking and director’s ownership of a firm on the market value of a firm is examined;
- (ii) to check whether there is a systematic difference in the relationship between  $q$  and the market capitalization group to which a firm attaches.

Model 1.3 tests the effect of CG practices, company characteristics, and the joint CG\_Rank-Director-Ownership of a firm on its valuation ( $Wq$ ). Six joint CG\_RankOwn groups are formed, and their assigned variable names are stated in brackets as follows:

- (i) High CG Rank and Low Directors' Ownership (HL);
- (ii) High CG Rank and Medium Directors' Ownership (HM);
- (iii) High CG Rank and Predominant Directors' Ownership (HP);
- (iv) Low CG Rank and Low Directors' Ownership (LL);
- (v) Low CG Rank and Medium Directors' Ownership (LM); and
- (vi) Low CG Rank and Predominant Directors' Ownership (LP).

The HL group is selected as the base group for comparison with the other five CG\_RankOwn groups: HM, HP, LL, LM, and LP. Correspondingly, five dummy variables are assigned to them: DV\_HM, DV\_HP, DV\_LL, DV\_LM, and DV\_LP, respectively. These dummy variables act as explanatory variables in Model 1.3 to test if  $Wq$  is affected by the joint characteristics of CG ranking and Director's Ownership.

The regression results in Table 10.6 show that, for the S sample of SmallCap firms (Model 1.3\_S), the coefficients in all five dummy variables DV\_HM, DV\_HP, DV\_LL, DV\_LM, and DV\_LP are negative. This is not found in the other two samples. To ascertain the outcomes of the regression results, robustness tests are conducted.

Firstly, a robustness test with regard to the classification of SmallCap firms into 6 different joint categories of CG\_RankOwn using a non-parametric Kruskal-Wallis Rank Test is conducted. Kruskal-Wallis test is derived from the  $F$ -test (which is the classical test under normality) by replacing the actual observations by their ranks (Neave and Worthington, 1992). It does not require the assumption of normally distributed populations. The theory of the Kruskal-Wallis test is based on a specific null hypothesis, namely, that the populations are identically distributed. The requirements for the validity of the test are that the samples are independent of each other and that the populations are continuously distributed. The null hypothesis to be tested is:

$$H_o: Q_{HL} = Q_{HM} = Q_{HP} = Q_{LL} = Q_{LM} = Q_{LP}$$

where  $Q_{HL} \dots Q_{LP}$  are the median  $Wq$  for the CG\_RankOwn groups of HL...LP, respectively.

If the null hypothesis  $H_0$  is not rejected, then the ranks of those observations should be randomly distributed between the 6 separate groups, i.e., each group should have its fair share of low, medium and high ranks. Thus, if  $H_0$  is true, the mean of the ranks assigned to one group should not differ much from the mean of the ranks for any other group. The  $H$  test statistic is based on comparing each group's mean rank with the mean of all the ranks, adjusted by the effect of unequal sample sizes. Table 10.27 shows the results of the Kruskal-Wallis rank test.

**Table 10.27 Kruskal-Wallis rank test on mean  $Wq$  of 6 CG\_RankOwn Groups**

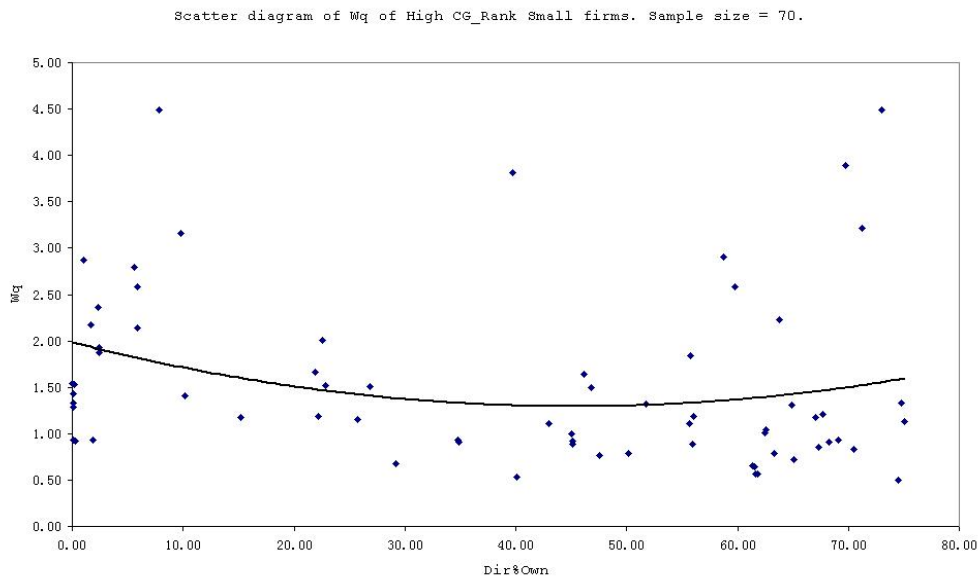
Group	Sample Size	Sum of Ranks	Mean Ranks
HL	24	2422	100.917
HM	14	882	63.000
HP	32	2196	68.625
LL	18	1207	67.056
LM	23	1459	63.435
LP	29	1704	58.759
Sum of Squared Ranks/Sample Size			724298.8
Sum of Sample Sizes			140
Number of Groups			6
H Test Statistic			17.303
Critical Value			11.070
$p$ -Value			<b>0.004</b>

From Table 10.27, it can be seen that the Kruskal-Wallis Rank Test shows an  $H$  statistic with a  $p$ -value of 0.004, which is highly significant. Hence the null hypothesis is rejected. It implies that the six CG\_RankOwn groups do not have the same mean of market value ( $Wq$ ). Hence, the formation of these six CG\_RankOwn groups in the regression Model 1.3\_S appears to be robust.<sup>9</sup>

A further check on the robustness of the regression results of Model 1.3\_S is provided by plotting a scatter diagram of  $Wq$  against Dir%Own for the SmallCap firms that have a high CG\_Rank. Using EXCEL trend-line function (polynomial), a U-shape curve can be fitted into the data (Figure 10.11). It suggests that a non-linear relationship exists between a firm's market valuation ( $Wq$ ) and its director's ownership (Dir%Own).

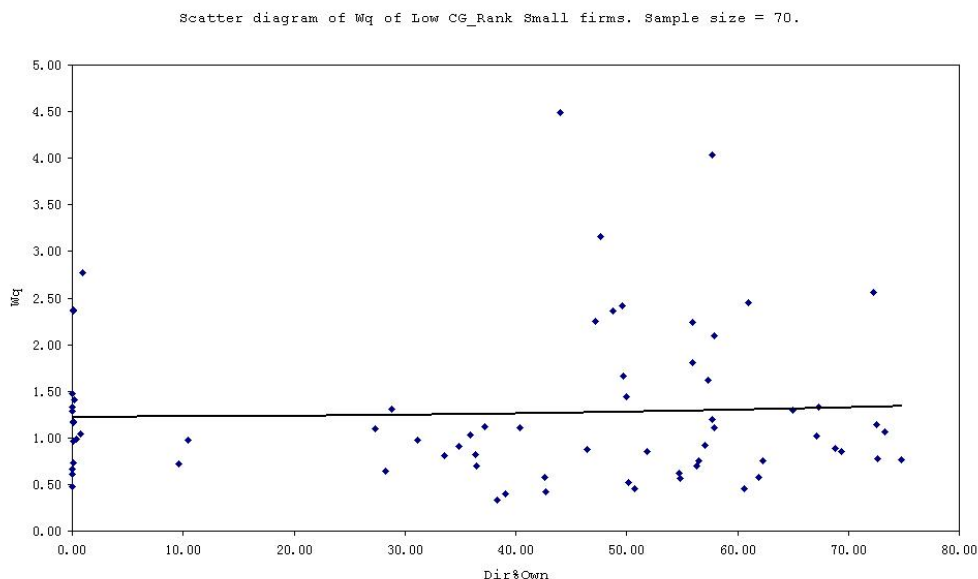
<sup>9</sup> Similar Kruskal-Wallis Rank Test is also applied to the L+M subgroup. The  $p$ -value is 0.393. The null hypothesis cannot be rejected at 0.05 significance level. Hence, the mean  $Wq$ 's of the different CG\_RankOwn groups within the L+M subgroup are not significantly different from each other.

**Figure 10.11 Scatter diagram of  $Wq$  of High CG\_Rank SmallCap firms**



In contrast, using the same function to plot a polynomial trend-line in the scatter diagram of  $Wq$  for the SmallCap firms with low CG\_rank, a slightly upward trend along  $Wq = 1.2$  is obtained as directors' ownership ( $Dir\%Own$ ) increases (Figure 10.12).

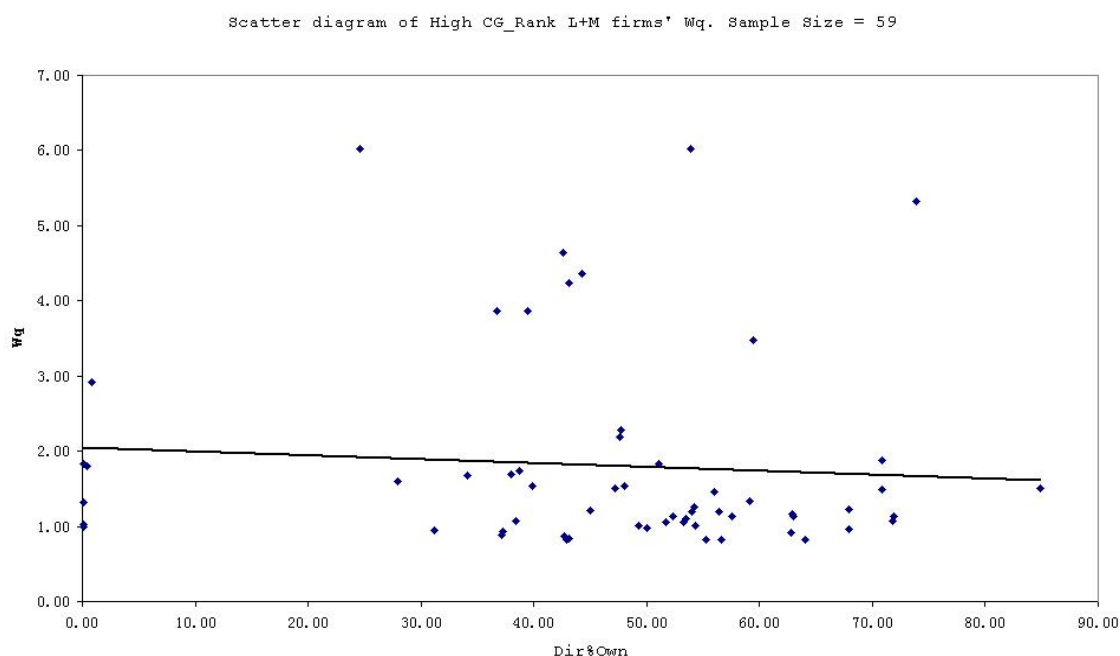
**Figure 10.12 Scatter diagram of  $Wq$  of Low CG\_Rank SmallCap firms**



Comparing Figure 10.11 with Figure 10.12, it can be seen that the pattern of  $Wq$  for high CG\_Rank firms is different from that for low CG\_Rank firms. Thus splitting SmallCap firms into groups of high CG\_Rank and low CG\_Rank appears to be meaningful. For firms with high CG\_Rank,  $Wq$  decreases first with increasing level of director's ownership and then increases gradually when directors' ownership increases to a predominant level. A slightly U- shaped pattern therefore appears (Figure 10.11).

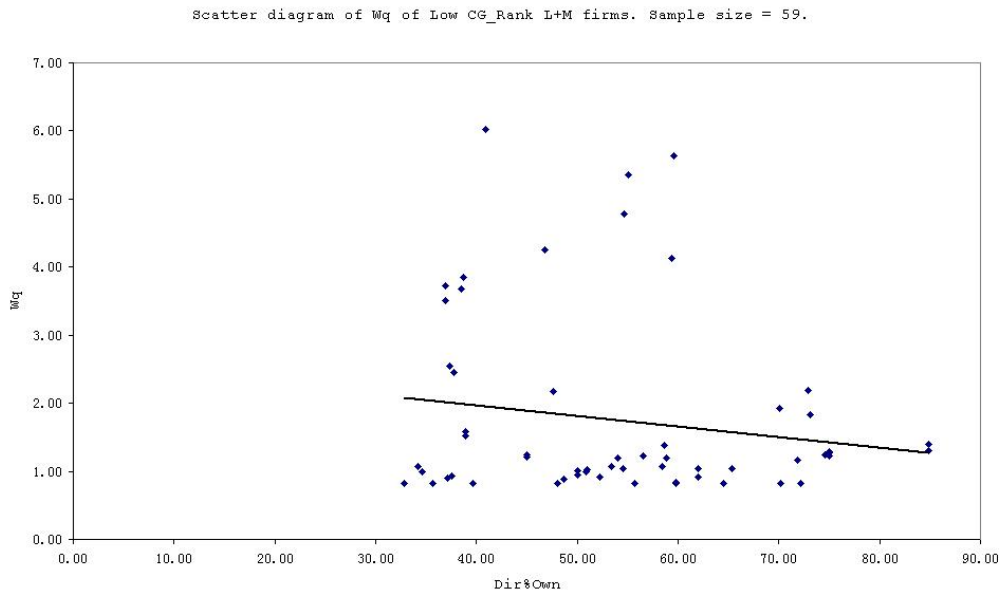
Scatter diagrams on the combined L+M sample of LargeCap and MidCap firms are also plotted for comparison (Figures 10.13 and 10.14). The scatter diagrams reveal a pattern which is different from that for the SmallCap firms. For high CG ranking firms in the L+M sample, there is a decreasing trend of market valuation ( $Wq$ ) as directors' ownership (Dir%Own) increases (Figure 10.13). The presence of three outliers of  $Wq$  (which is  $q$  after winsorization already) on the upper part of the scatter diagram may be causing a disproportionate influence on the negative slope of the trend line.

**Figure 10.13 Scatter diagram of  $Wq$  of High CG\_Rank L+M firms**



For low CG ranking firms, the decrease in  $Wq$  is more rapidly with increasing level of ownership, as demonstrated in a steeper downward slope of  $Wq$  (Figure 10.14). It suggests that, in a sample composed of LargeCap and MidCap firms, the higher the director's ownership (Dir%Own) in a firm, the lower is its market valuation ( $Wq$ ). The evidence is consistent with the hypothesis that entrenchment problem, as represented by high directors' ownership, is a major concern for investors in valuating a LargeCap or MidCap firm if the firm is not transparent in their CG disclosure. The results of robustness tests conducted above for Model 1.3 support the validity of the findings of the regression models.

**Figure 10.14 Scatter diagram of  $Wq$  of Low CG\_Rank L+M firms<sup>10</sup>**



(Note: There is no firm that falls in the category of Low CG\_Rank that has also a Low Dir%Own(0-25%), hence, the trend line appears to be truncated.)

### 10.10.3 Robustness test on Model 3.2a using Rank Regression

A robustness test is conducted on Model 3.2a to determine if systematic differences exist in the relationship between  $q$  and the grouping of firms by their market capitalization. A non-parametric test, Rank Regression, is undertaken. Comparing with a least-square regression, a rank regression is less affected by extreme values or outliers in both the dependent variable and the independent variables. Model 3.3 sets out to test the variables used in Model 3.2a by means of a Rank Regression. The results are shown in Table 10.28.

Model 3.3: Testing the value relevance of the Firm Group and interaction with CGDscore using rank regression, based on 258 samples.

$$\begin{aligned}
 Rank\_q = & \beta_0 + \beta_1 Rank(CGscore) + \beta_2 \sum Rank(CGprac_{i,t}) + \beta_3 \sum Rank(ComChar_{i,t}) \\
 & + \beta_4 Rank(DV\_M) + \beta_5 Rank(DV\_S) + \beta_6 Rank(CG*DV\_M) \\
 & + \beta_7 Rank(CG*DV\_S) + \varepsilon_{i,t} \dots \dots \dots (Model\ 3.3)
 \end{aligned}$$

**Table 10.28 Results of the Rank Regression of Model 3.3**

Predictor	Coefficient		Std Error		t-stat	
	Rank Reg	Least-sq Reg	Rank Reg	Least-sq Reg	Rank Reg	Least-sq Reg
Intercept	10.787	12.338	1.709	2.086	6.31	5.91
CGscore	-0.002	-0.005	0.007	0.009	-0.29	-0.56
BoDSize	-0.020	-0.067	0.036	0.044	-0.56	-1.52
NumINED	0.014	0.061	0.107	0.131	0.13	0.47
INED %	-0.006	-0.013	0.012	0.014	-0.50	-0.93
Dir%Own	-0.003	-0.001	0.002	0.003	-1.50	-0.33
SplitRole	0.021	0.161	0.102	0.124	0.21	1.30
DualList	-0.058	-0.040	0.110	0.134	-0.53	-0.30
ROE	0.017	0.020	0.003	0.004	5.67	5.00
LnSales	0.168	0.176	0.047	0.058	3.57	3.03
W_SalGrow%	-0.001	-0.001	0.001	0.001	-1.00	-1.00
LnEqty	-0.501	-0.542	0.057	0.069	-8.79	-7.86
Debt/TA%	-0.017	-0.025	0.003	0.003	-5.67	-8.33
DV_M	-0.445	-0.491	0.354	0.433	-1.26	-1.13
DV_S	-1.662	-2.001	0.377	0.460	-4.41	-4.35
CG*DV_M	0.001	0.002	0.007	0.009	0.14	0.22
CG*DV_S	0.006	0.009	0.007	0.009	0.86	1.00
Hodges-Lehmann estimate of tau = 0.8548    Least-squares S = %2						

It can be seen from Table 10.28 (under the column ‘t-stat’) that the *t*-statistics of the coefficients under the rank regression (Rank Reg) are similar to those under the least-square regression (Least-sq Reg). They are similar in signs and sizes. Those explanatory variables that are significant in the least-square regression are also found to be significant in the rank regression. As the tests of rank regression and of the least-square regression give the same outcome, the least-square regression at Model 3.2a is robust.

## 10.11 Summary

This Chapter focuses on describing the test results of the models based on Chapter 8, and discusses the outcomes of the models in light of the five key hypotheses developed in Chapter 6. The models are tested with reference to the three samples representative of (i) a mixture of firms at various levels of market capitalization that most prior research has been using in studying the effect of corporate governance on the value of a firm; (ii) firms of large market capitalization; and (iii) firms of small market capitalization.

Hypothesis *H1* states that firms that voluntarily disclose more information about their CG practices have higher market valuation than firms that disclose less, *ceteris paribus*. Test results of the models support this hypothesis for the sample of S (i.e., SmallCap) firms. At a low, medium, or predominant level of directors’ equity ownership, a SmallCap firm that



discloses more CG information (and thus attains a higher CG ranking) is often associated with a higher market valuation  $q$ . This finding is different from that of prior research in which no conclusive relationship has been found between market valuation and CG disclosure. Other governance aspects such as the split roles of Chairman and CEO, and cross listing, are found to be positively related to a firm's market value for the pooled sample of L+M+S (i.e., LargeCap, MidCap, and SmallCap) firms and the combined sample of L+M (i.e., LargeCap and MidCap) firms, controlling for the firm's financial performance (proxied by sales and return on equity) and its capital structure (proxied by equity and leverage).

Hypothesis  $H2$  postulates that the level of voluntary CG disclosure by a firm is affected by factors including: insiders' ownership; the number of independent executive directors (INED) on the board; a firm's resource availability; the status of cross listing of the firm; and, the split roles of Chairman and CEO, as suggested by extant researchers (in Chapter 3 and Chapter 4 of this study). The test results show that directors' ownership has a negative impact on disclosure for the pooled L+M+S sample and the S sample. The higher the insider ownership, the lower is the voluntary CG disclosure made by the firm. This finding is in line with the findings by Eng and Mak (2003) that lower managerial ownership is associated with increased voluntary disclosure.

The test results also show that two aspects, namely the performance of a firm (as proxied by return on equity (ROE)), and the split roles of Chairman and CEO, are found to be positively related to the level of voluntary CG disclosure for all L+M+S, L+M, and S samples. It can be concluded that firms with better performance tend to disclose more CG information voluntarily, and that where the roles of Chairman and CEO are held by two separate persons, more CG information is voluntarily disclosed. The test results do not show any evidence to support the hypothesis that CG disclosure is related to the number of Independent Non-Executive Directors (INEDs) in a firm, the percentage of INEDs on the board, the availability of resources (proxied by LnTA) to a firm, or the status of cross-listing of a firm, as conjectured in prior research.

Hypothesis  $H3$  hypothesizes that there are systematic differences in the voluntary CG disclosure between LargeCap firms, MidCap firms, and SmallCap firms. There are hypothesized differences in the market valuation as proxied by  $q$ , the level of CG disclosure, and the value relevance of the CG disclosure. The ANOVA test results show

that there are statistically significant differences in terms of  $q$ ; but no such difference is observed in the voluntary CG disclosure of the three capitalizations of firms. Nor do these firms systematically differ from one another in terms of the value relevance of CG disclosure.

The findings suggest that any different effect of CG disclosure by firms on their market valuation may not be necessarily attributable to their difference in market capitalization. The findings lay the foundation for interpreting the results of further hypothesis testing of this study. The test results do indicate that there are systematic differences in the market valuation  $q$  amongst the three groups of firms. This finding is not unexpected, as apart from the non-financial information such as CG disclosure of a firm, investors would consider other factors including the financial strength of a firm, the historical performance of a firm etc., in arriving at a market valuation. With the different characteristics inherent in LargeCap firms, MidCap firms and SmallCap firms, it is not surprising to find that systematic differences may exist among the firms that are not capable of being reflected by their respective capitalization.

Hypothesis  $H4$  relates to the relationship between the dividend payout (DivPay) and the CG disclosure of a firm. The test results show that DivPay is not directly affected by CGDscore, but is primarily driven by other variables relating to the financial performance of a firm. For LargeCap firms and MidCap firms, the CG practices variables are found to impact on DivPay, but no such impact is found for the SmallCap firms. The test results suggest that there may be other explanatory variables not captured in the model to account for the level of dividend payout for SmallCap firms.

Further tests are conducted to investigate, under a strong legal protection regime, if high CG ranking firms would have lower dividend payout ratios, *ceteris paribus*, than low CG ranking firms, at comparable level of directors' ownership. The hypothesis is supported by evidence found in the S sample as well as the pooled L+M+S sample. For SmallCap firms in the S sample, high CG ranking firms are found to have a *lower* dividend payout than low CG ranking firms, if the level of directors' ownership is medium (i.e., 25% - 50%). Furthermore, in the L+M+S sample, high CG ranking firms are often found to have a *lower* dividend payout than low CG ranking firms, if their directors' ownership level is medium (25% - 50%) or predominant (i.e., > 50%). Hence, CG ranking has a role to play in

mitigating the dividend payout ratio of a firm, even under a strong investor protection regime.

Hypothesis *H5* postulates that firms with insiders' ownership of 25% - 50% exhibit the lowest dividend payout ratio, *ceteris paribus*, on the belief that the probability of agency problem and of the entrenchment problem occurring is likely to be the lowest at this range of insider ownership (as explained in Section 6.3.5 in Chapter 6). The hypothesis is supported by the findings from Model 4.1\_S in the S sample (as illustrated in Table 10.20) for both high CG ranking and low CG ranking firms. It is also supported by the evidence found from Model 4.1\_LMS for the L+M+S sample with the low CG ranking firms. Thus, there is evidence that dividend payout can be jointly affected by voluntary disclosure of CG information (as proxied by CG ranking in Model 4.1) and insiders' ownership.

While some findings of this study echo those of prior research, other findings of this study are new, such as the relationship between CG disclosure and market value for small firms, and the voluntary disclosure of CG information as a substitute for dividend. The contributions and implications of the findings of this study, and suggestions for further research, will be addressed in the next chapter, Chapter 11.

# Chapter 11: Discussion, Contributions & Limitations of the Study, and Conclusion

## 11.1 Summary of thesis

This thesis examines the relationship between voluntary disclosure of corporate governance, firm valuation, and dividend payout. It hypothesizes that voluntary disclosure and firm valuation are positively related. Using the disclosure data of 258 firm-years observations for listed firms in Hong Kong over the 2003-2005 period, this study examines the impact of a firm's voluntary corporate governance (CG) disclosure on firm valuation proxied by the approximation of Tobin's  $q$ . The empirical findings indicate that voluntary CG disclosure has a statistically significant and positive effect on  $q$  for small firms, but not for the large- or medium-size firms. Small firms with lower ranking of voluntary CG disclosure have a lower market valuation. These findings are robust after taking into account of various firm-specific characteristics variables such as profitability, leverage, and sales growth.

Another key finding of this study is that voluntary CG disclosure can be a substitute for dividend payouts. Firms with higher voluntary CG disclosure are often the firms which offer lower dividend payouts, after controlling for profitability, leverage, and sales growth of the firm. In particular, small firms with medium level of insiders' ownership are also found to be those with the lowest dividend payout, when compared to other levels of insiders' ownership.

These empirical findings are observed from firms operating in Hong Kong, a business environment that is characterised with high concentration of insiders' ownership under a strong legal investor protection regime. The findings appear to suggest that, even if there is a strong legal systems to protect investors' interests, investors still rely on a firm's corporate governance disclosure to enhance their investment protection. If the corporate governance is not up to the investors' expectations, the market valuation of the firm will be lower and investors will demand high dividend payout. The implication is that, by voluntarily disclosing more CG information to investors, managers can enjoy a double benefit of enhancing the firm's market valuation and reducing the dividend payout.

The methodology used in this thesis involves coding the sample firms' CG practices and information that are disclosed in the firms' annual reports for fiscal year 2003-2005. The coding is based on a checklist derived from *Appendix 23* of the Listing Rules of the Hong Kong Exchange (HKEx), 2005. The checklist contains 66 single-barrel questions, each of which can be answered by a 'Yes' if the information is disclosed, 'No' if there is no disclosure, or 'Not Applicable' if the question does not apply to the firm. A Corporate Governance Disclosure Score (CGDscore), which is the number of 'Yes' answers divided by the net number of applicable questions and multiplied by 100, is constructed. Following similar treatment by previous researchers in constructing a disclosure index, all questions in the checklist are assigned with equal weighting.

Sample firms are drawn from the constituent stocks of the Hang Seng Hong Kong Composite Index (HSHKCI), which classifies Hong Kong listed firms into LargeCap (L), MidCap (M), and SmallCap (S) firms according to the ranking of their market capitalization. The composition of the HSHKCI is determined by the company that prepares the Hang Seng Index for the Hong Kong Exchange. The sample firms are selected as at September 2005 when the data collection of this study began. The firm valuation is proxied by an approximation of Tobin's  $q$ . Market performance and financial performance data such as profitability, total sales, and leverage are collected from Datastream.

This chapter proceeds as follows. Section 11.2 examines the key empirical results of this study in relation to previous research literature. Section 11.3 evaluates the significance of the findings and their implications, and concludes the entire thesis. Section 11.4 highlights the contributions of this study to the knowledge in Corporate Governance research. It also discusses the limitations of this study. Finally, Section 11.5 proffers some suggestions for further research.

## 11.2 Discussion

This study primarily investigates whether or not firms that disclose larger voluntary corporate governance (CG) information benefit from higher firm valuation than firms with less voluntary disclosure of CG. The results of the statistical tests performed in this study, support the general hypothesis that voluntary disclosure of CG practices have value relevance for small firms. A SmallCap firm's valuation can be positively and significantly

enhanced if it is more transparent in its disclosure. For example, in Model 1.0\_S, the CG disclosure score (CGDscore) has a coefficient of 0.007 and is statistically significant in explaining a SmallCap firm's  $q$ . If the CGDscore rises by one standard deviation (20.54) from the mean (40.05) to 60.59, the market valuation  $q$ , *ceteris paribus*, can be expected to increase by 0.14 (i.e.  $0.007 \times 20.54$ ). Since  $q$  is a ratio that clusters around the mean 1.42 for SmallCap firms, a 0.14-point increase will enhance firm valuation by an economically significant 9.9%. However, such value relevance of voluntary CG disclosure does not seem to be present for the pooled sample of LargeCap and MidCap firms (Model 1.0\_LM in Chapter 10, which denotes Model 1.0 applied onto the combined sample of LargeCap and MidCap firms). The following discussion aims at explaining this paradox.

### **11.2.1 Voluntary CG disclosure affects firm valuation of Smallcap firms which have less communication channels**

The empirical result of this study shows that disclosure of CG information affects a firm's market valuation positively for SmallCap firm, but not so much for the LargeCap or MidCap firms. This finding is consistent with the prediction of some previous voluntary disclosure theories. Firstly, Verrecchia (1983) proposes that higher quality information is accompanied by more voluntary disclosure by managers. He argues that information of higher quality implies a lower threshold level of disclosure, and therefore a greater probability of disclosure. It implies that, if managers withhold information of higher quality, "the market discounts the value of the asset (i.e., the firm) further than it would otherwise" (*ibid*, 1983, p.375). By the same reasoning, managers are expected to voluntarily disclose *more* if they believe that their corporate governance is of a *higher* quality than their competitors'. It sets the background that, for the sample firms in this study that had engaged in voluntary CG disclosure, the managers presumably would have to be convinced that their disclosure is of higher quality than their competitors'; otherwise, they would not have disclosed voluntarily. Thus, the content of disclosure is deemed to be truthful and credible.

Secondly, analysts tend to focus more on LargeCap and MidCap firms. Lang and Lundholm (1993) point out that more analysts tend to follow large firms than small firms, and therefore large firms may be subjected to a greater demand for information. Hossain, Perera and Rahman (1995) find empirical evidence in their study on 55 New Zealand firms that voluntary financial disclosure levels vary with firm size; and that "firm size

contributed most to explaining the variability in disclosure level” (*ibid*, 1995, p. 81). Their findings are consistent with another empirical study by Lang, Lins, and Miller (2004), who conclude that the larger the firm size is, the higher is the analysts’ coverage. Firm size, therefore, accounts for the differences in the variety of communication channels as well as the amount of information to be disseminated to the financial markets.

Thirdly, it has been found that for economic reasons, analysts tend to pay lesser attention to SmallCap firms. The aggregate demand for analyst services increases with firm size because of increased benefits of private information for larger firms (Bhushan, 1989a). King, Pownall, and Waymire (1990) offer a *transactions cost hypothesis* which predicts that disclosure increases with firm size because the incentives for private information acquisition are greater for large firms where the profit to trading on private information is much higher. Their hypothesis finds support in Lev and Penman’s (1990) empirical study that shows more earnings forecasts are reported in the financial press for large firms than for small firms. This leads to a higher cost of disseminating disclosures for small firms because the news media are more likely to carry stories about large firms and that analysts are more likely to attend their meetings (Lang and Lundholm, 1993). These findings indicate that, generally speaking, small firms cannot expect to receive equal attention from media as large firms do in terms of communicating high quality information to outside investors.

The above-mentioned studies tend to agree that the communication channels available to large firms and small firms are very different. Large firms attract institutional investors, international blockholders, and very often have more analysts’ following because of their sheer size, their resources put into investor relations (e.g., frequent road shows and presentations<sup>1</sup> to analysts), and their long working relationship with investment bankers, brokers, and financial intermediaries. As a result, large firms are more likely than small firms to carry out more frequently private meetings and/or video conferencing between the insiders and these outside stakeholders. Information about a firm’s CG practices may be communicated through these face-to-face discussions without necessarily being disclosed in a written medium such as annual reports or press releases. They need not be confined to annual reports or quarterly reports only.

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<sup>1</sup> Francis, Hanna and Philbrick (1998) point out that presentations to analysts have more advantages over other forms of voluntary disclosure. Face-to-face presentations offer broader scope, higher flexibility, and greater credibility because the analysts can affect the content of managements’ disclosure during the presentation which differs from press releases where management determines what matters are addressed.

In contrast, small firms' managers face more challenges even if they are eager and willing to disclose more and highly trustworthy information. Small firms have fewer resources; and disclosure of information is often costly (Verrecchia, 1983; Dye, 1986; Wagenhofer, 1990). Compared to larger firms, the communication channels available to small firms are limited.

The empirical results of this study indicate that small firms with more voluntary disclosures of their CG are associated with a higher market valuation, whereas large or medium firms are not. This is also consistent with the findings by previous researchers on small firms and family firms. It is very likely that managers of LargeCap and MidCap firms in Hong Kong have at their disposal a wider variety of channels to reach the outsiders (e.g., annual and quarterly reports, press releases, conferences with blockholders and institutional investors, interviews with business reporters and editors, and financial analysts meetings) than those of SmallCap firms. Larger firms also have a larger set of information to disseminate to the investors, and to capture the attention of analysts and other potential capital providers. Compared with large firms, the information set faced by small firms is smaller and the interest levels accrued to small firms lower.

Compared with other types of communication channels, annual reports are the most official, credible (because they are audited), and cost-efficient vehicle to reach all the shareholders, bondholders, and other stakeholders alike. Managers of small firms with limited resources tend to rely upon annual reports in their voluntary disclosure of quality information in a credible manner. Correspondingly, outside investors also tend to depend upon the information disclosed in the annual reports to re-adjust their investment decisions for the small firms. Hence, more voluntary disclosure in the annual reports by the small firms has a more direct and positive effect in their market valuation; whereas the same for the large or medium firms is not that pronounced, probably because the same information may have already been disclosed through other channels.

As such, it is sensible and justifiable for those SmallCap firms with better CG structure and practices than their peers to voluntarily disclose *more* CG information in order to stand out from the rest, using a credible channel of communication such as the annual reports. On the one hand, investors demand information, both financial and non-financial, to assess the uncertainty and risks of their investment in a firm so that they may adjust their investment strategy accordingly. They need information to determine the intrinsic value of the



investment (Singhvi and Desai, 1971) and to assuage their concerns for potential expropriation by insiders (Johnson, La Porta, Lopez-de-Silanes, and Shleifer, 2000). Companies satisfy this demand in part by supplying voluntary information on their CG. On the other hand, managers are concerned with how voluntary disclosures of non-financial information impinge on their firms' reputations, influence their firms' relations with their stakeholders, affect their firms' negotiations with regulatory bodies, or change the behaviour of their competitors (Dye, 1986). Unlike proprietary information which may reduce the present value of cash flows of the firm if disclosed to a strategic opponent (Wahenhofer, 1990), information on CG is non-proprietary and is unlikely to add competitive advantages to a strategic opponent. Therefore, there is good incentive for a value-maximizing manager to voluntarily disclose credible, non-proprietary, information to the market (Dye, 1986). By voluntarily disclosing more information on their CG practices, these firms are signalling to the market that they have less to hide about their state of CG. When such signals are credibly disseminated and correctly interpreted, investors will favour the stock of these good CG firms with a higher market value or a lower cost of capital. Under such scenario, voluntary disclosure of CG by the SmallCap firms works positively towards reduction of the information gap, provides more assurance to outsiders about their true state of corporate governance, thereby enhances investors' confidence in the management of the SmallCap firms. The empirical findings (e.g., Model 1.0\_S) of this study provide evidence that those SmallCap firms employing such signals are recognised by the market with a higher market valuation.

### **11.2.2 More voluntary disclosure is more credible, hence can proxy for better quality disclosure**

The findings of this study also lend support to the theoretical arguments by Lang and Lundholm (1993) in affirming that more voluntary disclosure can proxy for better quality disclosure. According to Lang and Lundholm (1993), there are three main motivations for voluntary disclosure: (i) to overcome adverse selection; (ii) to reduce transaction costs in the market; and (iii) to reduce expected legal costs by pre-empting large negative stock price responses to earnings announcements (*ibid*, 1993, p.247). The reason for voluntary disclosure of CG falls mainly under the first motivation: namely, *to overcome adverse selection*.

Past literature has pointed out that adverse selection in information asymmetry can lead to market failure (Akerlof, 1970). Information asymmetry would promote unwillingness to trade among buyers and sellers. It would increase the cost of capital as investors “price protect” against potential losses from trading with better-informed market participants (Bhattacharya and Spiegel, 1991). To improve their access to capital markets, managers of good CG small firms need to take initiatives to reduce the information asymmetry between outsiders (investors) and insiders so as to differentiate themselves from those firms of lower CG quality. Failure to do so may cause the outsiders to believe that they are no different from other firms with poor CG and refuse to invest or to demand a higher rate of return, leading to a reduction in the company’s share price. In contrast, managers of large or medium firms have no such urgency for taking initiative to reduce the information asymmetry through CG disclosure in the annual report, given all the other channels of communication with investors open to such companies.

This need for distinguishing the good CG firms from the bad CG firms is also in line with the “screening” rationale for voluntary disclosure of non-proprietary information as put forward by Dye (1985) and Lev and Penman (1990). Dye (1985) assumes that virtually every firm will disclose completely its non-proprietary information to distinguish itself from other firms with worse information. Lev and Penman (1990) hypothesize that investors will consider those managers of non-disclosing firms as withholding information that would imply a market value below an average valuation of all firms. Such non-proprietary information disclosure theories can be extended to voluntary CG disclosure. If investors know that some CG practices are implemented in the firm about which the manager has information but has not released, they will infer that the current market price of the firm overstates the firm’s values, based on the unfavourable information withheld by the manager (Dye, 1985). Accordingly, investors will revise downwards their demands for the firm’s shares, and the share price of the firm will fall precipitously until the price drops to a level similar to those of firms practising equally bad CG. Any downward price revision of poor CG-disclosure firms will, in turn, encourage those with good CG to screen themselves out of the group by voluntarily disclosing more. By this reasoning, more voluntary CG disclosure will be deemed to be more credible, and tend to be a proxy for a firm’s CG quality.

The empirical findings of this study do find evidence to support this screening-out argument. Small firms with lower voluntary CG disclosure (i.e., below median) are indeed

associated with lower market valuation (Model 1.3\_S in Chapter 10 refers). And the lowest market valuation is associated with a low CG ranking small firm with predominant insider ownership (>50%) highly susceptible to entrenchment problems. This result is consistent with the hypothesis by Claessens and Fan, (2002), which suggests that a higher confidence in a firm's CG leads to a smaller discount in the share price that investors would be willing to pay for the firm's stock. The test result of Model 1.3\_S in Chapter 10 of this study agrees with the conjectures by Sengupta (1998), who posits that firms that consistently make timely and informative disclosures are perceived to have a lower likelihood of withholding value-relevant unfavourable information. As a result these firms are charged a lower risk premium, hence leading to a higher market value.

In Hong Kong, SmallCap firms have a higher concentration of ownership than LargeCap firms (the mean percentage of equity ownership by directors, Dir%Own, is 50.82% for the SmallCap firms; compared to 45.54% for the LargeCap firms as reported in Chapter 9). Fan and Wong (2002) show that high ownership concentration in Asian firms (including Hong Kong firms) is associated with opacity and low informativeness in their disclosure of accounting information. Such assertion can be substantiated from the findings of Model 2.0\_S of Chapter 10 in this study. The findings show that the level of voluntary CG disclosure decreases as the percentage of insider ownership (Dir%Own) increases for the SmallCap firms. The same negative relationship also holds for the Large and MidCap (L+M) sample firms although the relationship is not as much statistically significant as in the SmallCap sample. As SmallCap firms are less likely to be cross-listed (19% of the SmallCap sample firms in this study have dual listing, as compared to 41% of the LargeCap and MidCap sample firms as reported in Chapter 9), Smallcap firms are therefore less likely to receive as much attention from international investors and analysts as much as LargeCap or MidCap firms do. The information asymmetry between outsiders (i.e. investors) and insiders (i.e. managers) for the SmallCap firms seems likely to be greater.

Because less transparency means higher risks to outsider investors, the investors are not willing to pay a high price for the stock unless their concerns for potential exploitation by the insiders are allayed and their fear for tunnelling by the majority shareholders are alleviated (Verrecchia, 1983, 1990; Claessens and Fan, 2002). Thus, for those SmallCap firms that have been facing an information asymmetry relatively bigger than that facing the LargeCap and MidCap firms, more voluntary CG disclosure can proxy for better quality of

CG, create a stronger impact on outsiders, and lead to a higher market valuation, *ceteris paribus*. This may explain why the value relevance effect of voluntary CG disclosure is stronger for the SmallCap firms but less prominent for the LargeCap and MidCap firms in this study.

### **11.2.3 Joint effect of voluntary CG disclosure and insider ownership on market valuation of SmallCap firms**

Another key findings of this study is that, among those SmallCap firms with low voluntary CG disclosure, firms with a medium level of insiders' ownership (25%-50% Dir%Own) are associated with the highest market valuation (Fig.10.2 in Chapter 10), as compared to small firms with other levels of insiders' ownership. This is consistent with the predictions offered by agency theory and entrenchment theory. In agency theory, it is predicted that at low level of insiders' ownership (e.g., 0-25% Dir%Own for firms in this study), agency problems are expected to arise as the interests of managers are not aligned with the interests of the shareholders (Jensen and Meckling, 1976). On the other hand, in entrenchment theory, it is predicted that at high level of insiders' ownership (i.e., over 50% Dir%Own for firms in this study), the managers well entrenched because of their equity ownership become difficult to remove. The expropriation of minority shareholders by the predominant insiders becomes a distinct possibility (Claessens, Djankov, and Lang, 2000; Cheung, Rau and Stouraitis, 2006). Outside investors will discount the share prices for the shares of those firms if there is inadequate assurance that their investment is in good hands of management. A low level of voluntary CG disclosure does not seem to be able to deliver such assurance to the minority shareholders.

The empirical results of Model 1.3\_S in Chapter 10 indicate that firms susceptible to potential risks of expropriation by insiders (i.e., firms with predominant insiders' ownership) are associated with the lowest market valuation. The coefficient on the dummy variable for the LP group of firms (DV\_LP), with joint Low-CG\_ranking-and-Predominant Dir%Own, is -0.56, compared to zero for the base group of HL firms (i.e., High-CG\_ranking-and-Low-Dir%Own). Comparatively, firms prone to have agency problems (i.e., firms with low insiders' ownership) are assigned with a low but slightly higher market valuation (the coefficient on the dummy variable being -0.49). These results suggest that, under a legal regime which is renowned for strong investor protection such as Hong Kong, investors are comparatively more sceptical about the danger of tunnelling and

expropriation by insiders more than the risk of non-alignment of interests of the agent and the principal. This sentiment of investor fear is understandable because minority outsiders may face a total loss of their investment should expropriation by the predominant shareholder take place; whereas the agency problems arising from the traditional agency-principal conflict of interest could be ameliorated by resorting to remedial external governance mechanisms such as market for corporate control (Jensen and Ruback, 1983) and proxy contests (Pound, 1988) in a strong legal protection environment.

#### **11.2.4 Effect of splitting the dual role of Chairman/CEO is significant in enhancing market valuation for LargeCap and MidCap firms**

It is also found in this study that splitting the role of the Chairman and CEO is significant in enhancing market valuation for the LargeCap and MidCap firms (Model 1.1\_LM). However, the relationship is not significant at all for the SmallCap firms (Model 1.1\_S). This can be attributable to the differences in complexity and the business nature of the firms.

For SmallCap firms in Hong Kong, the roles of the Chairman and CEO are usually performed by the same person (Cheung, Stouraitis, and Wong, 2005, p. 527). Descriptive statistics reported in Chapter 9 of this study show that 51% of the SmallCap firms have dual roles of Chairman/CEO performed by the same person; whereas only 25% of the LargeCap and MidCap firms have duality. The high proportion of small firms having duality is probably because the Chairman is often the founder of the firm who is likely to be the most experienced manager to become the CEO of the enterprise.

If the firm is at a growing stage (as SmallCap firms likely are), or operating within a relatively less complex business environment (i.e., not as many market/product segments as in the case of LargeCap or MidCap firms), a duality in Chair/CEO may be beneficial because it speeds up the decision-making process, cuts short the bureaucracy within the firm's organizational structure, and promotes audacity in formulating and implementing competitive business strategies. However, vesting the dual roles of Chairman and CEO in one person will empower an individual with unchecked authority in the day-to-day management of the firm, which is hazardous to the principles of good corporate governance (OECD, 2004; Cadbury Report, 1992).

LargeCap and MidCap firms often operate in a more diverse and complex business environment than SmallCap firms do. Their businesses cover a wider spectrum of products/markets. Also, larger firms tend to employ more people, including professional CEOs to manage, control, and coordinate their business activities. Large firms have more resources, operate in multiple markets, and are involved in a variety of products. The scale of operation requires delegation of job responsibility and exacts performance accountability from all executives within the hierarchy of the firm. Opportunity for shirking and rent-seeking behaviour tends to arise if an effective internal control system is not installed or, is not operating properly. Therefore, an effective monitoring system is needed to provide check-and-balance on the responsibilities and authorities of various decision-makers at all levels, including the Chairman and the CEO for LargeCap and MidCap firms.

For larger and more complex firms, splitting the roles of Chairman and CEO becomes justifiable because the potential benefits of guarding against self-interest aggrandizement would outweigh the costs of power sharing between two individuals. The disclosure of role splitting is a significant CG practice to inform the outside investors that a monitoring control has been officially installed in the highest hierarchy of the company. Outsiders can be assured that their interests will be more protected than is the case when the two roles are merged into one and taken up by the same individual. Where the roles are split, and if the CEO is found to be pursuing his/her own interests above the company's interests, investors still have a last resort to appeal to the Chairman for monitoring and disciplining the CEO. A clear separation of the two roles made known to the outsiders reinforces such assurance that a separation of decision management and decision control is practised (Fama and Jensen, 1983b), and serves as a signal that the board is effectively exercising its governance role (Pfeffer, 1981). When the corporate governance is properly carried out, firm valuation is positively affected, as the concerns of the outsiders are addressed.

Splitting the roles of the Chairman and CEO, however, is not the panacea to firm performance problems across all sizes of firms (Baliga, Moyer, and Rao, 1996, p. 51). For the small firms, role splitting may create unnecessary bureaucracy or internal power strife in a relatively simple organizational structure dysfunctional to the firms' performance. With a relatively smaller product range and/or markets to deal with, a small firm with limited resources needs flexibility, quick response to market opportunities, and the ability

to control costs in order to survive and flourish. The administrative costs and financial costs of splitting the two roles of Chairman and CEO may outweigh the benefits for a small firm.

There are research studies showing that insider owners who are also managers can help enhance the market value of a firm. Villalonga and Amit (2006) find empirical evidence that family firms have a premium in market valuation  $q$  when the founder manages the business. However, when the family firm is not managed by the founder (i.e., split roles of Chairman and CEO), the premium turns into a discount. Their findings are contrasted with the observations by Miller, Le Breton-Miller, Lester, and Cannella (2007) who find that only family business with a lone founder and no other relatives serving as owners or managers outperform other non-family owned business in their market valuation  $q$ . Their findings are based on a sample of 896 U.S. firms selected from *Fortune 1000* companies from 1996 to 2000.

As the research objective of this study is not on the influence of founder-manager, or the number of members of the same family, on firm's valuation, this aspect has not been investigated. Nevertheless, the presence of family members on the board of directors may be a plausible factor mitigating the level of voluntary disclosure of CG information, thus causing a limitation to this study. As revealed from previous studies, in Hong Kong, firms of varied sizes are characterised with high concentration ownership by the insiders or members of the same family<sup>2</sup>.

#### **11.2.5 The joint effect of splitting the duality of Chairman/CEO and having a predominant shareholder on voluntary disclosure**

Classical agency theory regards managers as agents, and shareholders as principal of the firm (Jensen and Meckling, 1976, Fama and Jensen, 1983a, 1983b). Managers are held accountable for their decisions to the shareholders, whose representatives are elected to the board of directors. The CEO is therefore accountable to the board, which is being led by the Chairman. If the roles of CEO and Chairman are assumed by the same person, other directors may be subject to undue pressure to endorse the decisions made and/or plans proposed by the executives. On the other hand, if the role of Chairman is separate from the

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<sup>2</sup> The survey by the Corporate Governance Working Group of the Hong Kong Society of Accountants (HKSA) reported that over half of the Hong Kong listed firms in 1996 had a majority shareholder either by a family or an individual (HKSA, 1997).

CEO, it is more likely that the board of directors can fulfil its duties in monitoring the executives. Therefore, splitting the roles of Chairman and CEO is a symbolic way of ‘signalling’ that the board of directors is effectively exercising its governance role (Pfeffer, 1981). Managers tend to be more conscientious of the impact of their actions on the shareholders’ perception, leading to more voluntary disclosure.

The empirical findings in this study find support to the above theories. The test results of Models 2.0\_S and 2.0\_LMS (which test the relationship between CGDscores and the CG practices and company characteristics for SmallCap firms, and for the pooled sample of LargeCap, MidCap and SmallCap firms, respectively) in Chapter 10 show that splitting the dual roles is associated with a higher level of voluntary CG disclosure level for all firms. This is consistent with the principles of good corporate governance as suggested by OCED.

Previous research using samples of Hong Kong firms of various sizes has obtained similar findings. Gul and Leung (2004) find that the Chairmen/CEO duality is associated with lower voluntary disclosures, based on a sample of 385 non-financial firms of all sizes listed on the Hong Kong Stock Exchange in 1996. Their study, however, did not differentiate the small firms from the large firms; and their sheer sample size also suggests the possibility that the empirical result is susceptible to the predominant influence of small firms in their sample.

This study goes further than that of Gul and Leung (2004) by conducting the empirical tests on three groupings of sample firms of different levels of market capitalization. By comparing and contrasting the results from three samples, this study is able to discern that split roles of Chairman/CEO has statistically significant impact on voluntary CG disclosure for small firms, but not for large- and medium-sized firms (Model 2.0\_LM and Model 2.0\_S). The findings of this study further suggest that such a difference does not seem to arise from the firm’s financial characteristics such as profitability, sales, growth, total assets or leverage.

Test results of Model 2.0\_S in this study also indicate that higher insiders’ ownership (Dir%Own) significantly decreases the level of voluntary CG disclosure for the small firms. This finding also corroborates with similar studies on small firms in other strong legal investor-protection countries. In Canada, Wu, Hedges and Zhang (2007) find creditors incur high monitoring costs on small firms that have concentrated ownership with duality



in owner-manager. Wu *et al* attribute this to the more serious informational asymmetry problems in such highly ownership-concentrated small firms. In the U.S., Ali, Chen, and Radhakrishnan (2007) document evidence that family firms in the S&P 500 make less voluntary disclosure about CG practices in their regulatory filings than non-family firms. They argue that maintaining a lack of transparency of CG practices may facilitate getting family members on board without much interference from non-family shareholders (*ibid*, 2007, p.245). Their findings support previous research by Anderson and Reeb (2003), who find that family firms among the S&P 500 companies from 1992-1999 tend to have substantial family members' representation on the board. Anderson and Reeb (2003) state that the non-controlling shareholders' concern for the lack of transparency in CG practices would be reduced only if such family firms deliver superior performance. Higher insiders' ownership, therefore, appears to be associated with lower voluntary disclosure, and is closely related to the lower transparency of a firm's CG.

In summary, splitting the role of Chairman and CEO is statistically significant and positively related to voluntary CG disclosure for the SmallCap firms. But the level of disclosure is also negatively related to the level of insider ownership (Dir%Own). Regression results of Model 2.0\_LMS, Model 2.0\_LM, and Model 2.0\_S as reported in Chapter 10 indicate that higher Dir%Own reduces the voluntary CG disclosure.

To test whether the duality role (SplitRole) or insider ownership (Dir%Own) has a bigger impact on voluntary CG disclosure (CGDscore), a standardized regression is estimated on Model 2.0\_S for which the coefficients on SplitRole and Dir%Own are both *significant* and yet with opposite signs<sup>3</sup>, as shown in Table 11.1 below:

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<sup>3</sup> Similar standardized regression can also be re-estimated on Model 2.0\_LM for LargeCap and MidCap sample as the coefficients on SplitRole and Dir%Own also have opposing signs. However, the coefficient on SplitRole is not statistically significant (Model 2.0\_LM in Chapter 10 refers), hence re-estimating the standardized regression on Model 2.0\_LM may not yield meaningful analysis.

**Table 11.1 Standardized coefficients of Model 2.0\_S. Dependent variable = Standardized CGDscore.**

	1	2	3	4	5
1		<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>
2	Intercept	0.000	0.076	0.000	1.000
3	BoDsize	0.172	0.182	0.945	0.346
4	NumINED	0.042	0.211	0.199	0.842
5	INED_%	0.184	0.234	0.785	0.434
6	Dir%Own	-0.207	0.083	-2.486	<b>0.014*</b>
7	SplitRole	0.322	0.082	3.931	<b>0.0001**</b>
8	DualList	-0.030	0.083	-0.364	0.716
9	ROE	0.206	0.083	2.493	<b>0.014*</b>
10	LnSales	0.083	0.085	0.979	0.329
11	W_SalGrow	0.017	0.081	0.209	0.835
12	Ln(TA)	0.023	0.095	0.239	0.811
13	Debt/TA	0.082	0.096	0.855	0.394

(Note: *p*-value are bold if <0.10; \* if <0.05 ; \*\* if <0.01. Explanatory variables are standardized CGprac variables and ComChar variables. Sample size= 140.)

The standardized regression (Field, 2000, p. 74) is estimated as follows: first, the mean and standard deviation are computed for the dependent variable and all the independent variables individually. Then each variable is standardized by subtracting its mean and then divided by its own standard deviation. Finally, the standardized dependent variable is regressed on all the standardized independent variables. The coefficients thus estimated from this regression are called the standardized coefficients. The absolute value of the standardized coefficient for each independent variable indicates its impact on the standard deviation change of the dependent variable, holding other independent variables constant. Therefore, the explanatory power of the independent variables can be compared with each other on common unit of measurement. The significance and signs of all standardized coefficients remain unchanged as those obtained under the Ordinary Least Square regression model.

When Model 2.0\_S is re-estimated using regression analysis based on standardized variables, the standardized coefficient for SplitRole is 0.322 (Table 11.1, row 7, column 2) and the standardized coefficient for Dir%Own is -0.207 (row 6, column 2). It means that changing the SplitRole by one standard deviation while holding other variables constant would change the CGDscore by 0.322 standard deviations. On the other hand, changing the insider ownership (Dir%Own) by one standard deviation, holding other variables constant, would change CGDscore by -0.207 standard deviations. For Hong Kong SmallCap firms, splitting the roles of Chairman and CEO has a bigger impact in absolute terms than insiders' ownership has on the level of voluntary CG disclosure.

Results of this standardized regression suggest that, within a strong legal investor-protection regime such as Hong Kong, splitting the Chairmen/CEO duality has a bigger impact on voluntary CG disclosure. This finding is of particular relevance to SmallCap firms which are characterized with high insider ownership (mean Dir%Own =50.82%, Table 9.8, Chapter 9). Small firms in Hong Kong typically have higher insider ownership than large firms (as reported in the Descriptive Statistics of Chapter 9 in this study). When insider ownership predominates, a small firm with split roles of Chairman and CEO can ameliorate the adverse effect of high insiders' ownership on the firm's disclosure, and presents a strong signal to the outsiders that there is a check-and-balance mechanism installed inside the firm. It indicates that the CEO is subject to the monitoring by the board of directors (which in turn is led by the Chairman) and is no longer left with a free hand. More disclosure on a firm's CG practices is therefore to be expected.

#### **11.2.6 Voluntary CG disclosure can substitute for dividend payout for the SmallCap firms**

Another objective of this study is to determine the extent voluntary CG disclosure affects a firm's dividend payout. The results from Model 4.1\_S (which tests the relationship between DivPay and the joint CG\_Rank-and-Dir%Own for SmallCap firms) of Chapter 10 in this study show that, for the SmallCap firms, the higher-CG ranking firms are often associated with *lower* dividend payout. The relationship is statistically significant at the medium insider ownership (25-50%) and the predominant insider ownership (>50%) levels. In contrast, firms with lower-CG ranking are often *higher* dividend payout firms. It appears that voluntary CG disclosure and dividend payouts are substitutes, and that insiders' ownership has a mitigating effect on the substitution effect between disclosure and dividend payouts.

If dividend payout is construed as a response to investors' demand for a return on their investment, then the reported results in this study show that voluntary CG disclosure can be a substitute for dividend payout. By voluntarily disseminating more CG information to the market, a SmallCap firm can achieve two objectives at the same time. First, it can reduce its dividend payout. Second, it can enhance its market valuation. Such a substitution effect is present for the SmallCap firms but not so prominent for the subgroup of LargeCap and the MidCap firms (see Model 4.1\_LM). This finding has significant meaning in relation to the agency models of dividends as proposed by La Porta, Lopez-de-

Silanes, Shleifer, and Vishny (LLSV, 2000b). It is also consistent with the findings by Schooley and Barney (1994), which will be discussed in turn in the paragraphs that follow.

LLSV (2000b) propose two agency models of dividends: the *outcome model* and the *substitute model*. According to the outcome model, dividends are an outcome of an effective system of legal protection of shareholders. When the legal environment provides a strong protection to investors, the outsiders can rely on their rights of voting for directors to put their representatives on the board, force the board to a high dividend payout to protest against wealth expropriation by the controlling shareholder. Dividends are paid because minority shareholders pressure the insiders to disgorge cash. As such, dividends are an outcome of strong legal protection system.

LLSV (2000b) also argue for a substitute model which operates in a weak legal investor-protection system. The substitute model states that firms needing external capital will pay dividends to establish a reputation for moderation in expropriating shareholders. A reputation for good treatment of shareholders is worth the most in countries with weak legal protection of minority shareholders, who have little else to rely on. In contrast, the need for a fair-dealing reputation is weaker in countries with stronger investor protection. This substitute model of dividends implies that dividend payout ratios should be higher in weak legal protection regimes than in those with strong protection. Therefore, dividends act as a substitute for corporate governance.

This study provides empirical evidence showing that higher dividend is offered by firms with lower CG disclosure. For the pooled sample of L+M+S firms, the result of Model 4.1\_LMS shows that low CG ranking firms pay higher dividend than high CG ranking firms, both at the medium and at the predominant level of insiders' ownership. For the combined sample of L+M firms, the result of Model 4.1\_LM shows that low CG ranking firms pay higher dividend at the predominant level of insiders' ownership. Similarly, for SmallCap firms, the result of Model 4.1\_S also show that low CG ranking firms pay higher dividend than high CG ranking firms at medium and predominant levels of insiders' ownership. All these results indicate that firms with high CG ranking offer a dividend payout lower than firms with low CG ranking, controlling for the level of insiders' ownership. Hence, investors seem to be willing to accept a lower dividend payout rate if the firm has a high CG disclosure ranking. Otherwise, they would expect the firm to pay a higher dividend.

The empirical results of Models 4.1 in this study also suggest that the level of dividend payout is related to the level of insiders' ownership. In both the pooled sample of L+M+S firms and the sample of SmallCap firms, a 'V'-shaped relationship between dividend and insiders' ownership is observed for the low CG ranking firms (Figure 10.5 and Figure 10.7 in Chapter 10), showing that firms with medium insiders' ownership (25%-50%) are offering the lowest dividend payout, as compared to other levels of ownership. As firms with low levels of insiders' ownership are prone to agency problems and those with predominant levels of insiders' ownership are susceptible to entrenchment problems, outside investors may feel insecure, hence demand more dividend, from firms at these insiders' ownership levels.

The same 'V'-shaped dividend payout pattern with insiders' ownership is also observed for the high CG ranking SmallCap firms (Fig. 10.7 of Chapter 10), suggesting that outside investors would use the level of insiders' ownership as a guide to assess the potential risks of their investment likely to be expropriated by insiders. If the expropriation risk is relatively low, investors are contented with a lower level of dividend payout, provided that the SmallCap firm has a high CG ranking.

Both the high CG-ranking and low CG-ranking SmallCap firms exhibit a 'V'-shaped dividend payout pattern with insiders' ownership (Fig. 10.7 of Chapter 10), but high CG ranking firms can offer a dividend payout ratio even lower than that by the low CG ranking firms.<sup>4</sup> Given that insider ownership of firms does not change drastically over time (Zhou, 2001; also see the descriptive statistics shown in Chapter 9 of this study), the implication for such a 'V'-shape pattern is that firms can lower investors' expectation on dividend payout by being more transparent in their CG disclosure.

The theoretical underpinning between CG and dividends can be found in the work by Core, Holthausen, and Larcker (1999), LLSV (2000b), and Core (2001), who point out that firms with weaker CG have greater agency problems. When investors find themselves faced with greater agency problems either in the form of non-alignment of interests, or insiders entrenchment, they will demand higher dividend payout (LLSV, 2000b). Paying dividends would remove corporate resources from the control of insiders (Faccio, Lang, and Young, 2001). This is relevant to outside investors in particular to firms providing a CG disclosure

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<sup>4</sup> In the low insider ownership (0-25% Dir%Own) category, SmallCap firms with a high CG-ranking offer higher dividend payouts than low CG-ranking firms. However, the coefficient on DivPay in the regression model is not statistically significant. Hence, no definitive conclusion can be drawn on the relationship for this category of SmallCap firms.

which is lower than the average. The behaviour of demanding more dividend payment is also in accord with the “bird in the hand” notion of dividends theory as advanced by Bhattacharya (1979) and LLSV (2000b), which states that the shorter is the investors’ planning horizon, or the higher the investor’s urgency to realize wealth for consumption, the higher is the equilibrium dividend payout demanded of the firm. Only when the concern about agency problems is alleviated would the investors agree to a lower dividend payout.

Conversely, even though a higher dividend payout may not result from more voluntary CG disclosure, a firm with good CG practices that discloses more is perceived as taking positive steps to reduce the information asymmetry between the insiders and the investors. A lower cost of capital should, *paribus ceteris*, be expected to result because more investors are willing to subscribe to the firms’ shares. When a firm is able to have access to cheaper capital, it is more likely to have more leeway to improve its profitability. Botosan (1997) finds a negative association between the disclosure measure and the cost of equity capital for firms with *low* analyst following, but the results did not extend to firms with *high* analyst following. Botosan explains that the relationship between a firm’s disclosure and its cost of equity capital can differ, depending upon the information set already available to outside investors. Previous literature often regards the number of analysts following as a proxy for the extent of information asymmetry that exists between insiders and outsiders of a firm. As small firms may not often attract as many analysts’ following as the large or medium firms do, the information set is smaller when compared with the large firms. As such, the value of disclosure for the small firms tends to have a *bigger* impact on the cost of capital. Therefore, when a small firm discloses more information voluntarily and credibly, it appears more likely to be rewarded by the market with more access to a low cost of capital reflected by a lower rate of dividend payout and/or a higher market valuation.

The empirical relationship between dividend payouts, voluntary CG disclosure, and insider ownership identified in this study is also consistent with previous empirical research. Schooley and Barney (1994) find a parabolic relation between insider ownership and dividend payout. Based on 235 large, industrial, U.S. firms in 1980, they present empirical evidence that show dividend payout decreases when CEO ownership increases over the low levels of ownership, but increases when CEO ownership reaches a high level. Their empirical results reveal the same curvilinear relationship and similar level of statistical

significance when the dependent variable is changed from dividend payout to dividend yield, although the coefficient of determination of their revised model is larger. The difference between Schooley and Barney's study and this study is that their findings are based on large firms in the U.S. where diffuse ownership prevails. When ownership is diffuse, insiders need not attain a predominant level of shareholding (i.e. over 50%) before entrenchment creeps in.<sup>5</sup> Consistent with the findings of this study, firms of low insider ownership as well as high insider ownership in Schooley and Barney's sample have to pay a relatively higher dividend payout.

The 'V'-shaped relationship identified in this study on dividend payout and insiders' ownership is also corroborated by Faccio, Lang, and Young (2001)'s study, which finds that Asian firms with a shareholder holding more than 20% of voting rights pay higher dividends. Faccio *et al* interpret their results as showing that shareholders demand higher payouts because management is entrenched. Similarly, Chen, Cheung, Stouraitis, and Wong (2005) also find that the dividend yield for Hong Kong small firms show a negative relation with insider family ownership up to 10%, and a positive relation from 10% to 35%. Beyond 35% family ownership, the relation returns to negative although the coefficient is not statistically significant. However, when the dividend yield is replaced by dividend payout ratio in their regression model, no such 'V-shaped' pattern is observed between dividend payout and family ownership whatsoever. No explanation for such inconsistency is offered as no linkage to the firms' corporate governance has been examined either. Another caveat for their study is that their small firm sample is not officially defined by is only conveniently determined by the researchers<sup>6</sup>.

Taking together the findings from prior research literatures, the empirical results in this study suggest that voluntary disclosure of CG influences the firm valuation and the dividend payout. The effects of voluntary disclosure of CG are more far-reaching than a focus on legal protection issues alone could reveal.

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<sup>5</sup> Weston (1979) observes that hostile takeovers are often blocked in U.S. firms in which directors own 30% or more of the equity. Farinha (2003) find critical entrenchment levels for his sample firms change in 2 periods – 32% equity ownership in the sample of U.K. firms in 1991, and 25% equity ownership in the sample firms in 1996. He concludes that entrenchment level slightly above 30% ownership by the insiders is a constant feature for large firms.

<sup>6</sup>Chen *et al* collected data on 412 listed firms in Hong Kong during 1995-1998. They divided the sample into three equal sub-samples, based on stock market capitalization ranking. Their small firms sample comprised the lowest one third of the firms by market capitalization.

### **11.2.7 Non-Executives Directors have no impact on voluntary disclosure**

The empirical evidence of this study (Model 2.0) shows that neither the number nor the proportion of Independent Non-Executive Directors (INEDs) on the board has any significant impact on the level of voluntary CG disclosure. This is intuitively at odds with the theories of CG researchers who advocate the importance of having INEDs on the board (e.g., Fama and Jensen, 1983b, p. 314-315). Nevertheless, the finding is consistent with some previous empirical studies. For example, Forker (1992) argues that the presence of non-executive directors on the board reduces the benefits of withholding information for managers. It therefore gives managers incentive to disclose more information and, as the variance about the firm's uncertainty is reduced, better quality financial disclosures should result. Forker (1992) thus conjectures that the presence of INEDs is one of the means to attenuate agency costs; and therefore should be positively associated with a firm's financial disclosure. However, his study does not find significant empirical statistical support for his hypothesis.

In Asian country, Cheng and Courtenay (2006) find that board size and CEO duality are not associated with the level of voluntary disclosure based on a study of 104 listed firms selected from the Singapore Stock Exchange in 2000. They also document evidence that boards dominated by a majority of executive directors are associated with lower levels of voluntary disclosure, although the result is not statistically significant. They conclude that the level of board independence (33%) suggested by the Singaporean regulator does not appear to be high enough to provide a monitoring capacity that is supportive of higher levels of voluntary disclosure (*ibid*, p. 286).

One possible reason for the weak relationship between the INEDs and the firm's disclosure is that Hong Kong listed firms are only complying with the regulatory requirements rather than taking initiatives to seek more experienced candidates to serve as INEDs on their boards. Hong Kong listed firms were required to have at least two INEDs on their boards by December 31, 1994 (Chen and Jaggi, 2000, p. 297; Ho and Wong, 2001, p. 142; Chen, Cheung, Stouraitis, and Wong, 2005). Since then, there had been long discussion between the HKEx and its listed member firms to raise the minimum number of INEDs from two to three, which finally became a mandatory requirement in the *Listing Rules* in 2005. Between 2003 and 2005, the average number of INEDs for the LargeCap, MidCap, and the SmallCap firms in Hong Kong is 4.64, 3.65, and 3.09 respectively (see Chapter 9



Summary Statistics). Judging from such a small average number of INEDs above the minimum requirement, it can be seen that Hong Kong listed firms are not too keen on expanding the number of INEDs on their board voluntarily.<sup>7</sup>

Another study of Hong Kong firms by Chen and Jaggi (2000) finds that the ratio of INEDs to the total number of directors on the board is positively associated with the comprehensiveness of financial disclosures. However, their sampling period is from 1993-1994 and covers the 100 largest firms (effective sample size: 87) based on the book value of total assets in 1994. Chen and Jaggi (2000) also point out that in 1993, there were 21 firms (= 24%) in their sample which had fewer than two INEDs sitting on the board. Apparently, both the number of INEDs and the percentage of their representation on the board increased as a result of compliance with the Hong Kong Exchange's requirements (*ibid*, 2000, p. 298).

A third Hong Kong-based study by Ho and Wong (2001) hypothesizes that firms with a higher proportion of INEDs are more likely to have a higher extent of voluntary disclosure. Using a checklist developed by a Big-5 accounting firm (Ernst & Young) and a self-developed importance-adjusted relative disclosure index, Ho and Wong (2001) do not find any empirical evidence to support such a hypothesis. They conclude that the INEDs in Hong Kong firms are "likely to ensure that the company has complied with mandatory disclosure requirements", and are "still not actively pressing the company to disclose more non-mandatory information." (*ibid*, 2001, p.151). Hence, Ho and Wong (2001) remain sceptical as to the independence of the INEDs in Hong Kong and their effectiveness as a monitoring device because many INEDs are appointed by the CEO or the board chairman.

Their scepticism is shared by other researchers on Hong Kong firms (e.g., Chen, Cheung, Stouraitis, and Wong, 2005) and corroborated with prior survey on ownership concentration. The second report of Hong Kong Society of Accountants' (HKSA) Corporate Governance Working Group already confirmed that over half of the Hong Kong listed firms are majority-owned by a family or an individual (HKSA, 1997). With a highly concentrated family-ownership of all firms (the ten wealthiest families in Hong Kong owned 46.8% of the total market capitalization of the Stock Exchange of Hong Kong in 1996 – HKSA, 1997), the INEDs' impact on voluntary disclosure can be severely curtailed.

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<sup>7</sup> Chen, Cheung, Stouraitis, and Wong (2005) examine the number of INEDs in 412 Hong Kong listed firms during 1995-1998. They observe, on average, there are 2.8 INEDs on their sample boards. They state that "even this number probably overstates the proportion of really independent directors, since the corporate sector in Hong Kong is small and it may be difficult to recruit true outsiders" (*ibid*, 2005, p. 436).

The findings on INEDs in this study are consistent with those from prior research. The implications are that there is still much room for improvement for Hong Kong firms if the INEDs are to serve their purpose in reinforcing corporate governance of the firm, as encouraged and expected by the Hong Kong Exchange and other regulatory bodies.

### 11.2.8 Other findings

#### a) Board size and firm valuation

This study finds that large firms tend to have larger board size. As discussed in Chapter 9 (Descriptive Statistics), the mean board size is 15.31 members for the LargeCap firms, 11.35 for the MidCap firms and 9.61 for the SmallCap firms. Furthermore, the empirical regression results of Model 1.2\_LM in Chapter 10 show that board size is *negatively* related to market valuation proxied by  $q$  for LargeCap/MidCap firms, although the coefficients are not statistically significant. This is consistent with the study by Yermack (1996) who finds a significant negative relation between board size and Tobin's  $q$  for large U.S. industrial corporations between 1984 and 1991. Yermack argues that even if boards' capacities for monitoring increase with board size, the benefits are outweighed by other costs such as slower decision-making, less candid discussions of managerial performance, and biases against risk-taking. Nevertheless, he acknowledges that 'the negative relation between board size and firm value attenuates as boards become large' (*ibid*, 1996, p. 186).

The empirical results of Model 1.2\_S in Chapter 10 show that board size is *positively* related to market valuation for the SmallCap firms, although the coefficient is not statistically significant either. As noted in Chapter 9 (Descriptive Statistics), there is a higher percentage of SmallCap firms with duality of Chairman and CEO than in the other two samples. With the Chairman and CEO vested in the same person, a larger number of directors sitting on the board of SmallCap firms may be helpful in countering the omnipotence of the dual Chairman and CEO. More directors may also provide the diversity needed to secure critical resources and networking, enrich the business experiences of decision-makers; and improve the quality of monitoring and decision-making processes of the board of directors (Haniffa and Hudaib, 2006). Hence, SmallCap firms tend to benefit from a larger board size.

*b) Dual listing is positively associated with market valuation for LargeCap and MidCap firms*

The empirical findings of Model 1.2\_LM in Chapter 10 indicate that the status of dual listing is significantly and positively associated with a LargeCap or MidCap firm's market valuation. Cross listing on a more stringent stock exchange has been associated with providing extra protection for minority shareholders (Reese and Weisbach, 2002), and signalling on the quality of the firm (Fuerst, 1998). Under Hong Kong laws, investors of the LargeCap and MidCap firms have already enjoyed the level of investor protection similar to that available to investors of other firms. By dual listing on other stock exchanges (mainly on stock exchanges in the U.S. which practise even stricter regulations than the Hong Kong Exchange), firms are signalling to the investors that they are willing to expose themselves to more scrutiny under an additional legal regime; thereby reinforcing investors' confidence in their governance quality.

Dual listing is also costly to insiders. By deliberately accepting additional regulatory exposure to investor protection at extra costs, managers convey credibly their commitment to a higher level of disclosure and scrutiny associated with cross-listing (Fernandes and Ferreira (2008) to their investors. This study provides evidence that the cross listing status, which is symbolic of a more stringent level of corporate governance status of a firm, is able to provide more confidence to investors who are then willing to put a higher market value on the dual-listed LargeCap and MidCap firms.

It is also found in this study (Model 1.2\_S in Chapter 10) that dual listing for a small firm has a *negative* relationship with a firm's market valuation, although the relationship is not statistically significant. The small number and a low percentage (19%) of dual-listed firms in the SmallCap sample (as compared to 42% for LargeCap/MidCap firms<sup>8</sup>) may be accountable for the inconclusive result between dual listing and market valuation  $q$  for SmallCap firms. There is a possibility that the additional costs involved in dual listing are found not justifiable for a SmallCap firm by the investors who then accord a lower market value to those firms consequently.

This subsection has summarized and elaborated the empirical findings of this study. The implications of the findings are to be discussed in Section 11.3 below.

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<sup>8</sup> Between 2003 and 2005, 75% of LargeCap firms and 26% of MidCap firms were dual-listed. See Chapter 9 Descriptive Statistics for details.

### 11.3 Conclusions and implications

This study examines the relationship between voluntary disclosure of corporate governance (CG) practices and the market valuation of the firm under a strong legal investor-protection regime in a market with highly concentrated ownership. The findings of this study indicate that voluntary disclosure is useful in enhancing market valuation of a firm with a high concentration of insider ownership.

The findings of this study have implications to various stakeholders of the firm: the managers, the outsider minority shareholders, and the regulators. Fund suppliers such as institutional investors and investment bankers; financial intermediaries such as credit rating agencies and analysts; and regulators and accounting researchers will also find the empirical results useful in their own respective fields. These implications are discussed in turn as follows.

#### 11.3.1 Voluntary disclosure and market valuation

One implication of the findings in this report is that, under a strong legal protection regime, minority investors would still make reference to a firm's level of voluntary disclosure on its CG to assess their risks of expropriation by the controlling insider. Investors would have grave concern about a firm that is not transparent in corporate governance, and are not likely to support a firm's share price where predominant insider ownership exists. Conversely, they are much more willing to invest in a firm by subscribing or holding on to its shares where they perceive a low likelihood for agency problems. It is therefore necessary for the managers to take steps to address the concerns of the investors by reducing the information asymmetry and improving the information environment for their firms, through the release of genuine and credible CG information in addition to the mandatory financial information to the investors.

For more voluntary disclosure of CG information to impact positively on a firm's market valuation, there is a premise that the CG practices have to be well-designed, the CG structure properly in place, and the CG mechanisms truthfully implemented. With a continuous and stronger enforcement of the *Listing Rules* 2005 by the HKEx, a time will come when all the listed firms have installed the required CG mechanisms and implement the practices as prescribed by the *Listing Rules* 2005. By then, investors may not be able to distinguish the 'good' CG firms from the 'bad' CG firms based on the CG mechanisms installed and practised by a firm. Therefore, it is advisable for managers of the good CG firms to provide to the market more qualitative indicators, rather than quantitative metrics,

about their CG, in order that their firms can stand out as truly 'good' CG firms from all other firms that are merely complying with the regulations. Such qualitative indicators may include, among others, disclosure of the rationale for appointing an INED to the board, the criteria for determining the executives' compensation packages, the explanation for a strategic decision made, and the response time to investors' queries to the board, etc. At present, no qualitative indicators are mandated by the Listing Rules of HKEx. Voluntary disclosure of indicators as to the quality of CG practices will therefore provide a great aid to the outsiders in evaluating how fairly the minority shareholders are treated.

### **11.3.2 Investor protection**

In the presence of a high concentration of ownership and/or a predominant shareholder cum manager in a firm, protection of minority shareholders may be at risk. No active market for corporate control may discipline incapable managers who are well-entrenched. Dissatisfied minority shareholders can only resort to selling their shares than to exercising their limited votes on the firm's annual meetings, knowing that both inside and outside monitoring mechanisms can fail in providing adequate shareholder protection (Haniffa and Hudaib, 2006). Selling a firm's shares will precipitate a lower market value, leading to a higher cost of capital for the firm and hence making the prospect of the long-term profitability of the firm dubious.

Investors can be better protected from insiders' expropriation if they are aware of the inadequacy of the firm's corporate governance. Poor CG firms are not likely to voluntarily disclose more information about their CG practices. If they disclose some CG practices which in reality are not implemented, it will be tantamount to misrepresentation. Therefore, the regulatory body should monitor that any CG disclosure made has to be genuinely true; and that legal liability is to be imposed on the firm for any misrepresented disclosure in its corporate governance report (currently the HKEx does not require the CG report to be affirmed by auditors with regard to its truthfulness). Only when any voluntary disclosure is linked to legal liability can firms be expected to be cautious in their disclosure. In so doing, any voluntary disclosure in addition to the mandatory requirements will serve as a more effective indicator as to the true state of CG of a firm, adding more discriminating prowess between good CG firms and bad CG firms, and resulting in more investor protection to the outside investors.

### **11.3.3 Voluntary CG disclosure as substitute for dividend payout**

This empirical study has shown that a higher CG ranking firm can make a lower dividend payout without adversely affecting the firm's market valuation. Previous research literature has shown that investors are often sceptical about low dividend-payout firms due to the tunnelling and expropriation risks associated with the presence of a predominant shareholder. In the case of SmallCap firms of predominant insider ownership, they are characterised by duality of Chairman and CEO. Duality of the two roles implies a higher risk for the board to be dominated by the CEO, which lowers the firm's credit rating (Ashbaugh-Skaife, Collins, and LaFond, 2006) and leads to a higher cost of capital. Managers of small firms therefore can make use of voluntary CG disclosure as a tool to lower the outsiders' scepticism on the firm's CG, to upgrade the credit ratings for the firm, and at the same time to be able to save a higher proportion of earnings that will otherwise be distributed as dividend as reserves for future investment opportunities. Voluntary disclosure is a signal. By credibly disclosing a signal that a strong, effective, CG system has been established within the firm, the managers can provide assurances that the outsiders' assets are safeguarded, bondholders' interests well-served, and insiders' perquisites closely curtailed. The benefits of voluntary CG disclosure far outweigh the costs involved in practising them.

### **11.3.4 Firm valuation, ownership structure, and voluntary CG disclosure**

Accounting and Finance researchers are often interested in the relationship between firm valuation, ownership structure and the corporate governance of a firm. Many empirical studies have been carried out but the results are unclear. Cross-countries studies tend to focus on the large firms and compare the results of one country with the others. Single-country studies tend to study large, medium, and small firms as a pool and treat them as a homogenous group. The empirical results of this study show that small firms are different from firms of larger market capitalization in many ways, including the factors affecting their CG disclosure, the factors affecting market valuation, the effect of CG disclosure on the firm's market valuation, and the dividend payout with regard to CG disclosure ranking and insider ownership structure etc. Furthermore, the significance of some CG mechanisms (e.g., splitting the roles of the Chairman from CEO; dual-listing) may have a different impact in the case of small firms. The causes of such differences may be due to the limited ability of disclosing the CG information to the outside investors relative to large firms, the

much fewer choices of communication channels, and the much limited resources in communicating their CG information to the outside investors, and of a much lower interest level to financial intermediaries. The implication of this empirical study is that it is desirable to study the small firms separately from the large firms/medium firms to unveil more interesting findings. Accounting researchers may wish to take into account the innate differences between small firms and large/medium firms in conducting their studies.

This concludes the discussion and the implications of the findings in this study. The following section presents the contributions and limitations of this research.

## 11.4 Contributions and limitations of the study and future research

### 11.4.1 Contributions

Previous research literature relates firm valuation with a firm's ownership structure and residual claims (e.g., Fama and Jensen, 1983a; Demsetz and Lehn, 1985; Morck, Shleifer and Vishny, 1988; McConnell and Servaes, 1990; Himmelberg, Hubbard, and Palia, 1999). Based on the argument derived from agency theory (Jensen and Meckling, 1976), these researchers postulate that firm valuation is associated with ownership structure. Many empirical tests were carried out but the relationship found was not clear (i.e., monotonic, non-linear, and no relationship could be found at all). The findings of this study, among other similar work, suggest that these researchers have overlooked the role of corporate governance (CG) in the firm's valuation.

Since mid-1990s, other researchers focus on the relation between firm value and corporate governance. Several corporate governance mechanisms were employed in their studies, for instance: board size (Yermack, 1996); shareholder rights (Gompers, Ishii, and Metrick, 2003); market for corporate control (Cremers and Nair, 2005); overall corporate governance index (Black, Jang, and Kim, 2006), or an entrenchment index (Bebchuk, Cohen, and Ferrel, 2008); However, these studies did not link up ownership structure with corporate governance in the determination of market valuation. Neither did they distinguish small firms from large firms, thus leading to their inconclusive research findings.

This study contributes to this line of CG value relevance research in two ways: (i) it separates the small firms from the pooled sample of large, medium, and small firms; and (ii)

it identifies a *joint* effect of ownership structure and the voluntary disclosure of CG on the market valuation of a firm. The empirical test results of this study demonstrate that, when large, medium, and small firms are pooled together, the CGDscore shows no significant effect on firm valuation. Only when the small firms are studied separately is the impact on firm valuation unveiled (an increase of 0.008 in  $q$  for one point increase in CGDscore). This study hence provides strong support to Krole's (1995) argument that the conflicting findings of Morck, Shleifer, and Vishny (1988) and McConnell and Servaes (1990) on the relationship between market-to-book ratio (which is essentially close to Tobin's  $q$ ) and managerial ownership are due to the differences in the size of sample firms, rather than induced by the differences in insider ownership.

Second, this study also demonstrates that a combination of insider ownership and CG-ranking has a significant impact on firm valuation. A worst-to-best change in the joint CG-rank and ownership group predicts a 0.56 increase in Tobin's  $q$  (the coefficient on the dummy variable for Low-CG-Prominent-Ownership is  $-0.56$ , compared with the coefficient, 0, for the base case of High-CG-Low-Ownership). Even if the level of insider ownership is kept unchanged, a higher CG ranking predicts a minimum 0.10 increase in  $q$  (for the medium ownership range) and a maximum 0.49 increase in  $q$  (for the low ownership range). CG ranking does impact on a firm's valuation, and that the impact on firm's valuation differs across different levels of insider ownership.

Third, this study contributes further evidence that dividend payout is a *joint* function of the insider's voluntary CG disclosure and the firm's ownership structure. Previous similar studies on the relationship between ownership structure and dividend policy using Hong Kong firms seem to have overlooked the nature of small firms, or to have underestimated the joint impact of corporate governance mechanism and ownership structure on a firm's dividend policy. For example, Chen, Cheung, Stouraitis, and Wong (2005) find little relationship between family ownership and dividend policy<sup>9</sup>. They conclude that dividend payout of small firms is neither sensitive to firm performance nor to internal corporate governance mechanisms such as the percentage of INEDs on the board and the presence of audit committee (*ibid*, 2005, p. 431).

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<sup>9</sup> Chen, Cheung, Stouraitis, and Wong (2005), however, find a significant 'V-shape' relationship between dividend payout and family ownership for their sub-sample of small firms – dividend payout is decreasing when family ownership increases (up to 10%) and increasing when family ownership further rises (from 10% to 35%). Nevertheless, they did not find similar pattern in the pooled sample of 412 Hong Kong firms. No explanation is provided in their study.



Fourth, this study shows that dividend payout can be a substitute for investors' demand for good corporate governance, in that higher dividend payout is found for firms of low CG ranking. Conversely, if the corporate governance of a firm is above average, the dividend payout can be lower. This substitution effect is stronger for the small firms than for the pooled sample of firms of various levels of market capitalization. Investors appear to take a firm's *relative* corporate governance into consideration in their expectations on a firm's dividend payout. In this respect, outside investors are actively seeking additional information, and mechanisms, to help protect their investments from potential expropriation by the insiders.

Finally, this study contributes to the debate on LLSV's (2000b) agency models theory of dividends. It finds evidence that the substitution model of dividends operates not only in a weak investor-protection regime but also in a strong investor-protection environment such as Hong Kong where a high concentration of insider ownership prevails. Concentrated shareholdings are common in Asian countries (except Japan) as well as in European countries (except U.K.). In Hong Kong, highly concentrated ownership is the norm rather than the exception (e.g., Chen, Cheung, Stouraitis and Wong (2005) report that 61% of their Hong Kong sample firms have a family controlling at least 30% of the voting rights). Despite a strong legal protection regime (Hong Kong practises the Anglo-Saxon common law system), the presence of concentrated ownership poses a major concern for minority shareholders who seek higher dividend payout from firms with predominant insider ownership. To the outside investors, a Common Law legal regime does not appear to be strong enough to allay the fear of expropriation by entrenched insiders.

The above discussion sums up the key contributions of this study. In the following subsection 11.4.2, the limitations of this research are presented, followed by subsection 11.4.3 in which some suggestions for further study are outlined.

#### **11.4.2 Limitations**

The interpretation of the empirical results reported in this study is subject to several caveats and limitations. For instance, while a census rather than a sample is included in the LargeCap category, the small sample size of LargeCap firms (number of firm-years is 36) limits the power of the tests for differences across different market capitalization strata. For this reason, it has been necessary to combine the LargeCap firms with the MidCap firms in the analysis. Secondly, the insider ownership thresholds of 0-25%, 25-50% and

over 50% are in a way arbitrarily categorized, although this method of classification has been adopted in prior studies and is found appropriate in view of the actual position of insider ownership structure of the sample firms. Finally, the quantitative metric CGDscore may arguably be an acceptable measure at best to reflect the genuine state or quality of corporate governance practices of a firm. These limitations are discussed in turn as follows:

a) Sample size and sample selection

One limitation of this study is that the samples selected represent a group of firms conventionally defined as LargeCap, MidCap, and SmallCap firms; and pre-selected as constituent stocks of the Hang Seng Hong Kong Composite Index. These firms are therefore unlikely to be a random sample of all the firms listed on the Hong Kong Exchange (e.g., some firms domiciled in China and listed on the HKEx are not represented in the sample in this study). Consequently, the sample may have suffered from a self-selection bias and exhibited a systematic resistance to, or preference for, voluntary corporate governance disclosure, thereby reducing the within-sample cross-sectional variations on this dimension.

The limited sample size of LargeCap firms, which is predetermined *ex ante* by the index-making company HSICO, also imposes restrictions on the construction of sub-samples for follow-on analysis. For instance, there is nil entry for the joint category of Low-CG-and-Low-Dir%Own firms of the Kruskal-Wallis Rank Test of Model 4.1 in Chapter 10. The lack of qualified samples in this category weakens the explanatory power of Model 4.1\_LM for the LargeCap and MidCap firms. Subsequently, the comparison between Model 4.1\_S on SmallCap firms with Model 4.1\_LM on the effect of dividend payout of joint CG-ownership cannot be carried out category by category or contrasted with each other to the fullest extent. It would have been preferable to have a more varied sample of firms as well as a wider range of insider ownership is available for study. Had there been some large or medium firms that could qualify for that category, the explanatory power of the two models could have been enhanced considerably.

b) Insider ownership thresholds are arbitrary

A second limitation on this study is that the ownership structure is only arbitrarily classified into 3 categories: (i) low ownership (i.e. 0-25%); (ii) medium ownership (i.e. 25-50%); and (iii) predominant ownership (i.e. > 50%) to proxy for a firm's propensity to agency problems or entrenchment problems. Although this is following similar approach by previous researchers, there is far from consensus among researchers on a proper

methodology of ownership categorization, and each researcher has his/her own personal view of what constitutes a 'low' or 'medium' level of insider ownership.

For instance, Chau and Leung (2006) define shareholding of 0-5% as low level of ownership, 5-25% as medium level, and 25%-or-more as high level in their empirical study of 397 Hong Kong listed firms. They find that convergence-of-interest effect is dominant at the medium level and entrenchment effect is present at the high ownership level. Their ownership thresholds follow the classification by Morck, Shleifer, and Vishny (1988) whose study is based on Fortune 500 firms in the U.S. In contrast, Chau and Gray (2002) divide the outsider ownership into quartiles (1-25%, 26-50%, 51-75%, and 76-100%) to test for its relationship with the voluntary disclosure of strategic information, non-financial information, and financial information for listed firms in Hong Kong and Singapore. They report that outsider ownership is positively related to the extent of voluntary disclosure regardless of the level of ownership.

In Hong Kong, the HKEx requires 25% or more of the issued share capital of listed companies to be held by "unconnected persons" (those have no family relationships with members of a firm's board of directors) and the general public (Phenix, 1994; Chau and Gray, 2002; HKEx, 2005<sup>10</sup>). Therefore, in order to exercise unchallenged control over a firm, the amount of stock owned by a majority shareholder will have to exceed 50% but may not exceed 75% of the equity holding either. In the extreme case, a shareholder with 25% equity ownership may still be considered as a minority shareholder if the majority shareholder owns 75%. The classification of low, medium, and predominant ownership is therefore arbitrarily set at 0-25%, 25-50%, and above 50% in this study. Except for the present research, this tripartite classification has not been tested by economic theories and therefore an analysis based on such classification on ownership structure may produce different analytical results if the thresholds are altered considerably.

*c) Measurement of CGDscore may not reflect the quality of the CG practices of a firm*

A third limitation of this study is on the measurement of CG disclosure (CGDscore). Following Meek, Roberts, and Gray (1995), Botosan (1997), Haniffa and Cooke (2002), and Gul and Leung (2004), this study adopts a dichotomous approach in scoring the CG

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<sup>10</sup> Rule 8.08(1) of the *Listing Rules* provides that there must be an open market in the securities of an issuer and that this will normally mean that at least a prescribed percentage (normally 25%) of any class of listed securities must at all times be held by the public.

disclosure of a firm: according to the checklist prepared on the *Appendix 23* of HKEx *Listing Rules*, an item scores one if disclosed and zero if it is not. The CGDscore is the summation of the scores scaled by the total number of applicable answers to the checklist. The CGDscore in this study measures whether a particular CG mechanism or practice is disclosed, instead of evaluating the quality of the disclosure itself. It does not indicate whether a particular governance mechanism is optimal either.

Though it is commonly accepted to use a quantitative metric (e.g., an index) to measure disclosure, such metric does not reflect the true state of affairs of the company. It is often argued that more disclosures do not equate more quality disclosures (e.g., Ho and Wong, 2001; Khanna, Palepu, and Srinivasan, 2004). It should be cautioned that the disclosure score in this study is a quantitative assessment of the voluntary disclosure practices of a firm, hence a proxy for the firm's willingness to be transparent about its CG practices. It is not a qualitative indicator of the value of that information, or does it imply that a disclosure score of one firm twice as much as another firm's would infer that the CG practice of the former is twice as good as the latter's.

Finally, the CGDscore in this study is purely based on the CG information that is disclosed in the annual reports of the firms. It does not include or assess any information communicated to investors through other possible means of communication such as the world-wide web, road-shows, and direct contact with shareholders by the firm's investor relations/corporate affairs department. The amount of CG information disclosed through these channels, though not necessarily audited by external auditors or formally recorded in the Corporate Governance Report, may also shape investors' perception of the quality of CG practices within the firm.

### 11.5 Suggestions for further studies

Corporate governance (CG) research is important not only to academics but also to practitioners like accountants, auditors, investors and regulators. Recent financial crises such as the Asian stock markets crash (1997), collapses of Enron (2001), WorldCom (2002), Lehman Brothers (2008), and the global credit crunch in 2008 have amply illustrated that demise of corporations has its roots in corporate governance failures. Investors have the right to know to what extent their investments are being protected not only by external corporate governance mechanisms but also by internal corporate governance mechanisms of the firm. They need additional information, to which the

insiders have access, on top of the mandatory financial and non-financial disclosure to revise their investment strategies. Voluntary corporate governance disclosure by the firm can effectively reduce the information asymmetry that exists between the outsiders and insiders.

This empirical study has shown that voluntary CG disclosure has stronger value relevance to SmallCap firms vis-à-vis LargeCap or MidCap firms; and proposes that the reason being the information landscape and communication channels faced by the small firms are different from those of large/medium firms. Further research can be carried out in this regard to investigate how information technology (IT) can help a firm with restrained resources to reduce the information gap between the firm itself and outsider investors, to arouse higher interests from the financial intermediaries' interests in the firm, and to feed potential fund-providers with timely and credible information economically.

One potentially fruitful extension of this study would be to investigate how the *quality* of voluntary disclosure can be enhanced. As pointed out in Subsection 11.4.2 (Limitations) of this Chapter, the metric of voluntary disclosure in this study is a quantitative measure. It does not necessarily equate the quality of the corporate governance that is practised within the firm. Further research can explore into the ways that the quality of corporate governance can be credibly communicated to the outsiders by the firms.

This study is based on the voluntary disclosure data of firms in a period when the disclosure of CG information required by the Listing Rules has not been made compulsory for the listed firms in Hong Kong. To complement the arguments provided by this study, future research in this area may be conducted on the disclosure made by the same set of firms from 2006 onwards in order to evaluate the efficacy of value relevance of voluntary CG disclosure. A comparison between pre-event and post-event analysis can shed light on how effective a firm's voluntary CG disclosure can affect firm valuation.

Future study can also investigate into other variables that might influence the interaction between disclosure practices, information asymmetry, and market characteristics. The research into these areas should prove helpful to further the understanding of the impact of voluntary disclosure of non-financial information other than CG practices (such as the intangible assets, sustainability of business, and social responsibility reports) on firm market valuation under different kinds of ownership environments.

## Appendices and References

**Appendix 1: Hang Seng Hong Kong Composite Index constituent firms (as at 5 September 2005)**

**Panel A: Samples of Non-Financial Firms**

No.	HKEx Code	Market Cap	Company Name	Cross-listed Exchanges	Fiscal 2003 ARR date	Fiscal 2004 ARR date	Fiscal 2005 ARR date
LargeCap							
1	293	L	Cathay Pacific Airways		25/3/2004	8/4/2005	30/03/2006
2	001	L	Cheung Kong (Holdings)		2/4/2004	22/4/2005	20/04/2006
3	267	L	CITIC Pacific	ADR	6/4/2004	30/3/2005	10/4/2006
4	002	L	CLP Holdings	ADR	10/3/2004	14/3/2005	14/3/2006
5	012	L	Henderson Land Development	ADR, TSE	27/10/2003	27/10/2004	27/10/2005
6	003	L	Hong Kong and China Gas		26/3/2004	30/3/2005	25/4/2006
7	006	L	Hongkong Electric Holdings	ADR	13/4/2004	7/4/2005	10/4/2006
8	013	L	Hutchison Whampoa	ADR, LSE	2/4/2004	8/4/2005	20/4/2006
9	066	L	MTR Corporation	ADR	17/3/2004	16/3/2005	18/4/2006
10	016	L	Sun Hung Kai Properties	ADR	10/10/2003	11/10/2004	5/10/2005
11	019	L	Swire Pacific, 'A'	ADR	14/4/2004	19/4/2005	6/4/2006
12	087	L	Swire Pacific, 'B'	ADR	14/4/2004	19/4/2005	6/4/2006
13	004	L	Wharf (Holdings)		26/4/2004	22/4/2005	26/4/2006
MidCap							
1	522	M	ASM Pacific Technology		11/3/2004	11/3/2005	3/4/2006
2	1038	M	Cheung Kong Infrastructure Holdings		24/3/2004	1/4/2005	6/4/2006
3	688	M	China Overseas Land & Investment		28/4/2004	12/4/2005	2/5/2006
4	291	M	China Resources Enterprises		23/4/2004	21/4/2005	2/5/2006
5	330	M	Esprit Holdings	LSE	22/10/2003	30/9/2004	19/10/2005
6	2038	M	Foxconn International Holdings		N.A.	3/5/2005	2/5/2006
7	053	M	Guoco Group		29/10/2003	22/9/2004	23/9/2005
8	010	M	Hang Lung Group		22/10/2003	1/11/2004	14/10/2005
9	101	M	Hang Lung Properties		22/10/2003	1/11/2004	14/10/2005
10	097	M	Henderson Investment		27/10/2003	27/10/2004	27/10/2005
11	388	M	Hong Kong Exchanges and Clearing		5/3/2004	9/3/2005	24/3/2006
12	045	M	Hongkong & Shanghai Hotels		12/3/2004	16/3/2005	13/4/2006
13	054	M	Hopewell Holdings	ADR	23/9/2003	21/9/2004	23/9/2005
14	2332	M	Hutchison Telecom International	ADS, NYSE	N.A.	11/4/2005	24/4/2006
15	014	M	Hysan Development Co	ADR	24/3/2004	31/3/2005	31/3/2006
16	179	M	Johnson Electric Holdings	ADR	19/6/2003	23/6/2004	30/6/2005
17	683	M	Kerry Properties		24/3/2004	24/3/2005	10/4/2006
18	062	M	Kowloon Motor Bus Holdings		13/4/2004	1/4/2005	25/4/2006
19	494	M	Li & Fung		7/4/2004	7/4/2005	20/4/2006
20	017	M	New World Development Co		30/10/2003	29/10/2004	31/10/2005
21	659	M	NWS Holdings		30/10/2003	27/10/2004	28/10/2005
22	316	M	Orient Overseas (International)		6/4/2004	30/3/2005	27/3/2006
23	008	M	PCCW	ADR	19/3/2004	13/4/2005	13/4/2006
24	069	M	Shangri-La Asia		13/4/2004	15/4/2005	8/5/2006
25	083	M	Sino Land Co	ADR	7/10/2003	7/10/2004	14/10/2005
26	669	M	Techtronic Industries Co	ADR	21/4/2004	25/4/2005	26/4/2006
27	511	M	Television Broadcasts		31/3/2004	6/4/2005	12/04/2006
28	020	M	Wheelock and Co		28/7/2003	19/7/2004	20/7/2005
29	551	M	Yue Yuen Industrial (Holdings)		30/1/2004	31/1/2005	26/01/2006

Notes:

L = LargeCap; M = MidCap; S = SmallCap.

ADR = American Depositary Receipts; ADS = American Depositary Shares.

LSE = London Stock Exchange; NYSE = New York Stock Exchange; TSE = Tokyo Stock Exchange.

Only non-financial firms' stocks are included in the sample. Financial firms' stock are shown in Panel B.

No.	HKEx Code	Market Cap	Company Name	Cross-listed exchanges	Fiscal 2003 ARR date	Fiscal 2004 ARR date	Fiscal 2005 ARR date
SmallCap							
1	373	S	Allied Group		5/5/2004	28/4/2005	3/5/2006
2	341	S	Café de Coral Holdings		1/8/2003	28/7/2004	25/7/2005
3	057	S	Chen Hsong Holdings		30/7/2003	23/7/2004	28/7/2005
4	165	S	China Everbright		14/4/2004	6/5/2005	2/5/2006
5	1110	S	China National Aviation Co		19/4/2004	21/4/2005	2/5/2006
6	127	S	Chinese Estates Holdings		14/4/2004	26/4/2005	4/5/2006
7	035	S	Far East Consortium International		31/7/2003	2/8/2004	27/7/2005
8	142	S	First Pacific Co	ADR	31/3/2004	6/5/2005	20/4/2006
9	641	S	Fong's Industries Co		30/4/2004	26/4/2005	27/4/2006
10	420	S	Fountain Set (Holdings)		30/12/2003	29/12/2004	29/12/2005
11	709	S	Giordano International		31/3/2004	4/4/2005	4/4/2006
12	393	S	Glorious Sun Enterprises	ADR	26/4/2004	20/4/2005	27/4/2006
13	041	S	Great Eagle Holdings		23/3/2004	11/4/2005	26/4/2006
14	480	S	HKR International		7/7/2003	9/7/2004	1/8/2005
15	044	S	Hong Kong Aircraft Engineering	ADR	24/3/2004	8/4/2005	29/3/2006
16	050	S	Hong Kong Ferry (Holdings) Co		30/3/2004	29/3/2005	4/4/2006
17	715	S	Hutchison Harbour Ring		31/3/2004	25/4/2005	11/4/2006
18	1097	S	I-Cable Communications	ADR	20/4/2004	13/4/2005	25/4/2006
19	167	S	IDT International		3/7/2003	11/6/2004	28/6/2005
20	027	S	K. Wah Construction Materials	ADR	30/4/2004	15/4/2005	2/5/2006
21	173	S	K. Wah International Holdings	ADR	30/4/2004	15/4/2005	28/4/2006
22	034	S	Kowloon Development Co		7/4/2004	12/4/2005	11/4/2006
23	1212	S	Lifestyle International Holdings		N.A.	1/4/2005	31/3/2006
24	194	S	Liu Chong Hing Investment		29/3/2004	24/3/2005	30/3/2006
25	311	S	Luen Thai Holdings		N.A.	3/5/2005	2/5/2006
26	200	S	Melco International Development		3/5/2004	18/4/2005	26/4/2006
27	071	S	Miramar Hotel & Investment		8/7/2003	13/7/2004	14/7/2005
28	282	S	Next Media		30/6/2003	28/6/2004	21/6/2005
29	018	S	Oriental Press Group		26/6/2003	13/7/2004	12/7/2005
30	2343	S	Pacific Basin Shipping		N.A.	1/4/2005	15/3/2006
31	078	S	Regal Hotels International Holdings		5/5/2004	21/4/2005	9/5/2006
32	178	S	Sa Sa International Holdings		15/7/2003	13/7/2004	13/7/2005
33	583	S	SCMP Group		15/4/2004	18/4/2005	26/4/2006
34	983	S	Shui On Construction and Materials		4/8/2003	2/8/2004	28/7/2005
35	242	S	Shun Tak Holdings	ADR	19/4/2004	28/4/2005	9/5/2006
36	716	S	Singamas Container Holdings		7/4/2004	14/4/2005	13/4/2006
37	1221	S	Sino Hotels (Holdings)		7/10/2003	6/10/2004	14/10/2005
38	315	S	SmarTone Telecom Holdings		8/10/2003	30/9/2004	3/10/2005
39	2878	S	Solomon Systech (International)		N.A.	17/3/2005	24/3/2006
40	321	S	Texwinca Holdings		30/7/2003	30/7/2004	28/7/2005
41	1192	S	Titan Petrochemicals Group		15/4/2004	12/4/2005	27/4/2006
42	903	S	TPV Technology		1/6/2004	11/5/2005	20/4/2006
43	732	S	Truly International Holdings		16/4/2004	14/4/2005	12/4/2006
44	710	S	Varitronix International	ADR	5/5/2004	29/4/2005	27/4/2006
45	2317	S	Vedan International (Holdings)		16/4/2004	14/4/2005	6/4/2006
46	345	S	Vitasoy International Holdings		24/7/2003	28/7/2004	18/7/2005
47	303	S	Vtech Holdings	ADR	10/7/2003	9/7/2004	6/7/2005
48	049	S	Wheelock Properties		25/7/2003	15/7/2004	15/7/2005

Notes: ARR date = Annual Report Release date. Dates are stated in dd/mm/yyyy.



Panel B: Financial firms (as at 5 September 2005)			
HSHKCI constituent stocks that are not included in this study			
1	2388	L	Bank of China Hong Kong (Holdings)
2	011	L	Hang Seng Bank
3	005	L	HSBC Holdings plc
4	023	M	Bank of East Asia
5	183	M	CITIC International Financial Holdings
6	2356	M	Dah Sing Banking Group
7	440	M	Dah Sing Financial Holdings
8	302	M	Wing Hang Bank
9	096	M	Wing Lung Bank
10	331	S	China Resources Peoples Telephone Co
11	636	S	Fubon Bank (Hong Kong)
12	349	S	Ind and Com Bank of China (Asia)
13	626	S	JCG Holdings
14	1111	S	Liu Chong Hing Bank
15	065	S	Pacific Century Insurance Holdings
16	432	S	Pacific Century Premium Developments

**Appendix 2: Check List on CGDscore (source: HKEx 2005 *Listing Rule*, Appendix 23)**

**a. Corporate governance practices**

1. Is there a statement indicating the co. has applied the principles in the App.14 Code?
2. Is there a statement as to whether the co. meets the code provisions in the App. 14 Code?
3. If there is any deviation from the App. 14 Code, any details provided for deviation?

**b. Directors' securities transactions**

1. Has the co. adopted a code of conduct on terms no less exacting than the App. 10 Model Code?
2. Have the directors complied with the standard set out in the App. 10 Model Code?
3. If there is non-compliance, any details and explanation of remedial steps provided?

**c. Board of directors**

1. Is the composition of board disclosed by categories, number in each category, and by name?  
--Chairman  
--Executive directors  
--Non-executive directors  
--Independent non-executive directors
2. How many board meetings were held during the financial year?
3. How frequent is the attendance of each individual director, on a named basis, at the board meetings?
4. Is there a statement of how the board operates?
5. Details of non-compliance with Rule 3.10(1) & (2), if any, and an explanation of the remedial steps taken.
6. Reasons why an independent non-executive director is considered independent where that persons fails to meet the independence requirements state in Rule 3.13?
7. Relationship (e.g. financial, business, family, or any material/relevant types) among board members and between the Chairman and the Chief Executive Officer, if any, has been disclosed?

**d. Chairman and Chief Executive Officer**

1. The identity of the Chairman and Chief Executive Officer disclosed?
2. Are the roles of the Chairman and CEO segregated and not exercised by the same person?

**e. Non-executive directors**

1. The term of appointment of non-executive directors.

**f. Remuneration of directors**

1. The role and function of the remuneration committee, if any.
2. The composition of the remuneration committee, if any, including names and identity, esp. the committee chairman's.

**Is there a remuneration committee?**

**Committee chairman's name disclosed?**

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3. The no. of meetings held,  
the record of individual attendance of members, on a named basis, at meetings.
4. A summary of work, including determining the remun. policy of EDs, terms of service contracts of EDs.

**g. Nomination of directors**

1. The role and function of the nomination committee, if any.
2. The composition of the nomination committee, if any, on a name basis;  
2.a and the identity of the com. chairman.
3. The nomination procedures, process, & criteria to select candidates for directorship.
4. A summary of work, including the determination of nomination policy, of the nomination committee.
5. The no. of meetings held by the nomination committee, and the record of named individual attendance.

**h. Auditors' remuneration**

1. Remuneration analysis of the auditors' audit and non-audit services, including details of the service nature and fees paid.

**i. Audit committee**

1. The role, function, and composition of the committee, by names, and the identity of the com. chairman.  
**Committee chairman's name disclosed?**
2. The no. of audit com. meetings held,  
and the attendance record of members on a named basis.
3. A report on the work performed by the audit committee on its duties set out in the App. 14 Code.
4. Details of non-compliance with Rule 3.21, if any, and explanation of the remedial steps taken.

**Additional disclosure on the App. 14 Code provisions expected in the Corporate Governance Report:**

1. Acknowledgement from the directors of responsibility to prepare the accounts,  
and a statement by the auditors about their reporting responsibilities (App. 14 Code C.1.2).
2. Report on material uncertainties, if any, relating to doubts of the firm's going concern (App. 14 Code C.1.2).
3. A statement that the board has reviewed the effectiveness of the internal control system.
4. In case of different view from the board, the audit committee should issue a statement explaining  
its recommendation and explanation regarding the selection, appointment, resignation or dismissal  
of the external auditors (App. 14 Code 3.5.).

**Recommended disclosures (not mandatory or exhaustive)**

**a. Share interests of senior management**

1. The no. of shares held by senior management.

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**b. Shareholders' rights**

1. The way shareholders can convene an Extraordinary General Meeting.
2. The procedures any enquiries may be put to the board, and sufficient contact details for such enquiries to be properly directed.
3. The procedures for putting forward proposals at shareholders' meetings and contact details.

**c. Investor relations**

1. Any significant changes in the company's Articles of Association.
2. Details of shareholders by type and aggregate shareholding.
3. Details of last shareholders' meeting: time, venue, major items discussed, voting particulars.
4. Indication of important shareholders' dates in the coming financial year.
5. Public float capitalisation as at the end of the year.

**d. Internal controls**

1. Where a review of the internal control system has been conducted, the company should disclose:
  - 1.1 How the internal control system is defined;
  - 1.2 The procedures and internal controls to handle and disseminate price sensitive information;
  - 1.3 Whether the company has an internal audit function;
  - 1.4 How often internal controls are reviewed;
  - 1.5 A statement that the directors have reviewed the internal control system's effectiveness and whether they consider the system effective and adequate;
  - 1.6 Criteria to assess the effectiveness of the internal control system;
  - 1.7 The period which the review covers;
  - 1.8 Details of any significant areas of concern which may affect shareholders;
  - 1.9 Significant views or proposals put forward by the **Audit Committee**;
  - 1.10 Where there has not been a review, an explanation why the company has not done so.
2. A statement of how the company has complied with the internal control provisions set in App. 14 Code C.2.3.
3. The outcome of the annual review by the company without an internal audit function.

**e. Management functions**

1. The divisions of responsibility between the board and management.

Page 3

Yes	No	Not Appl.	
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			60
			61
			62
			63
			64
			65
			66
Total Count: (= 66)			

## Appendix 3

Figure A1.1 Frequency distribution of  $q$  for LargeCap firms, 2003-2005

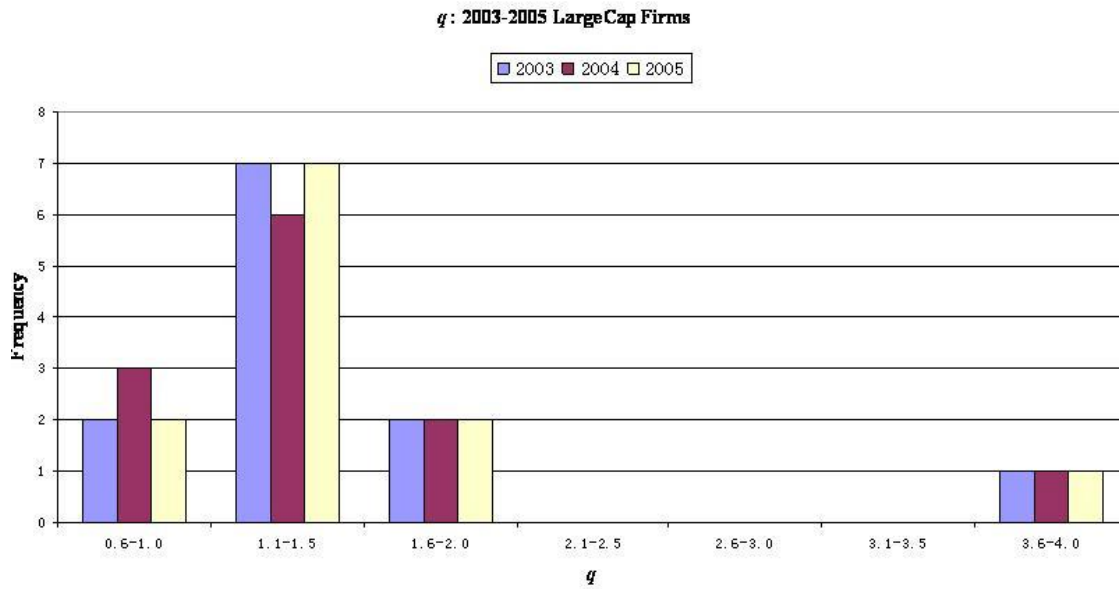
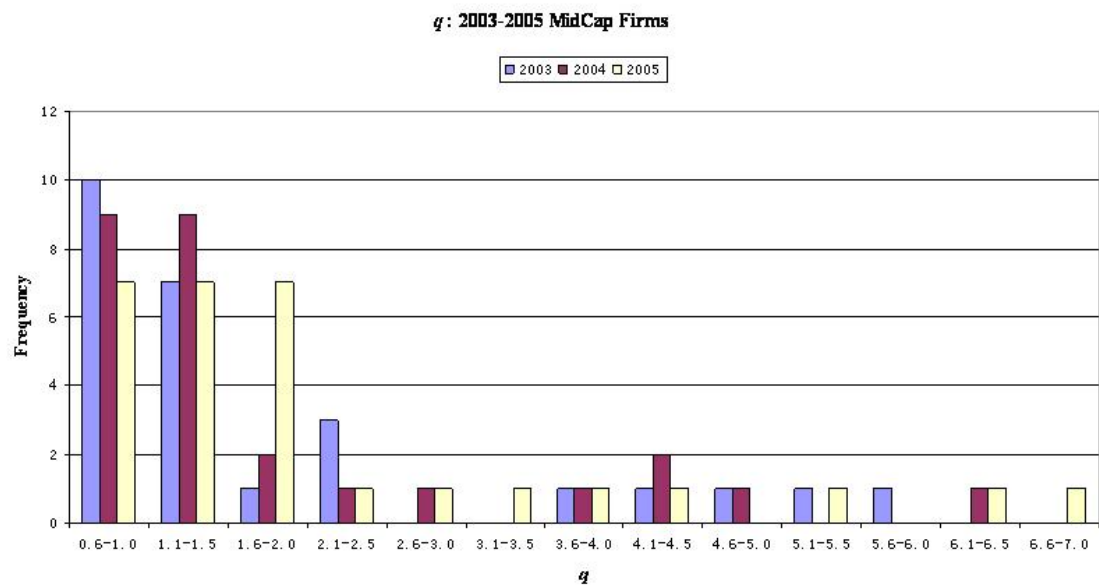
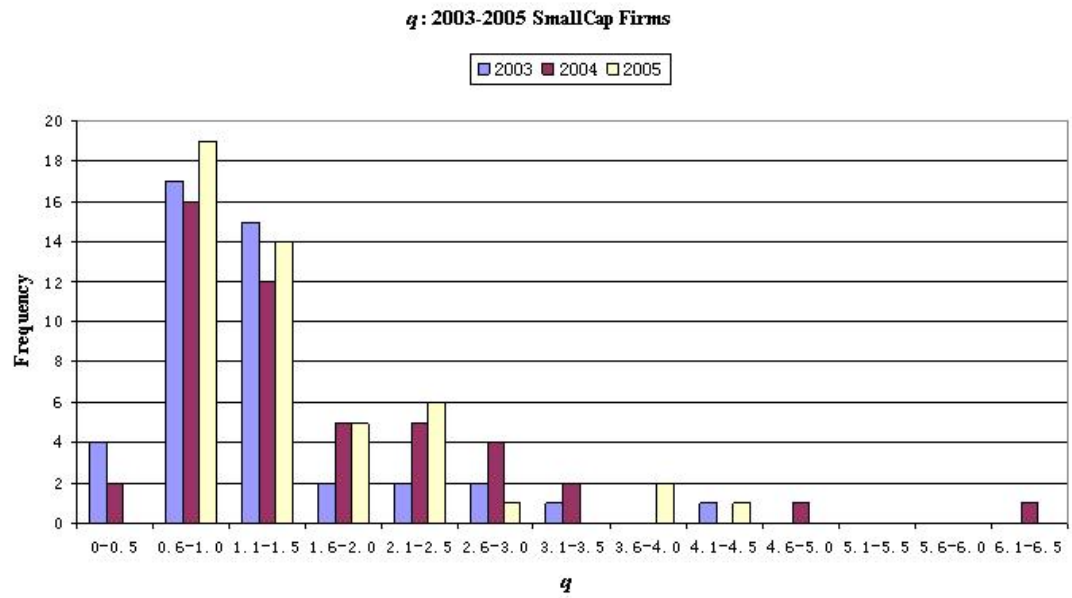


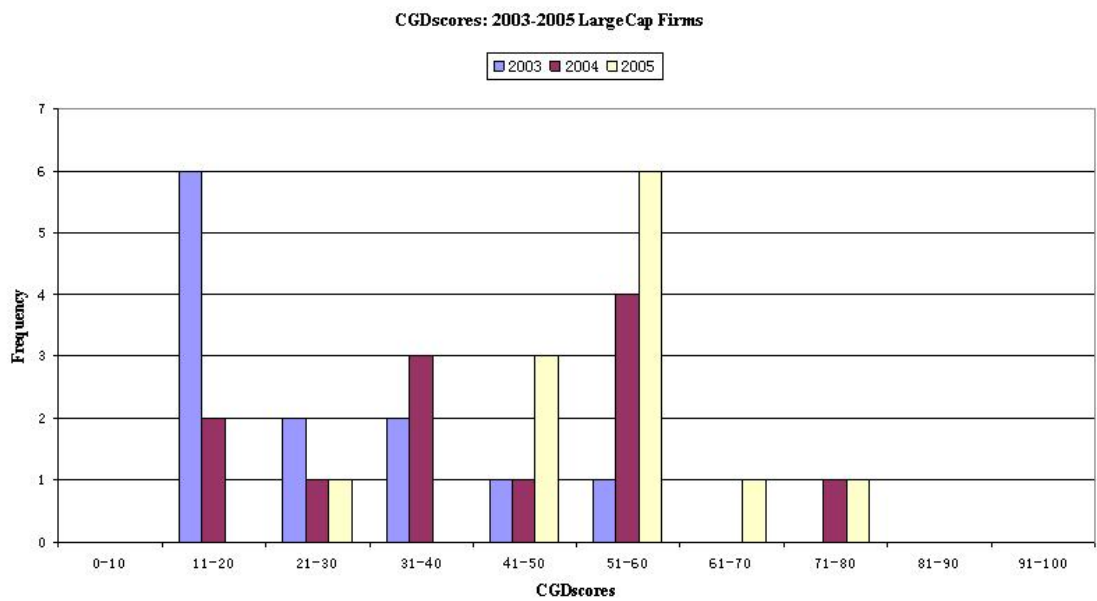
Figure A1.2 Frequency distribution of  $q$  for MidCap firms, 2003-2005



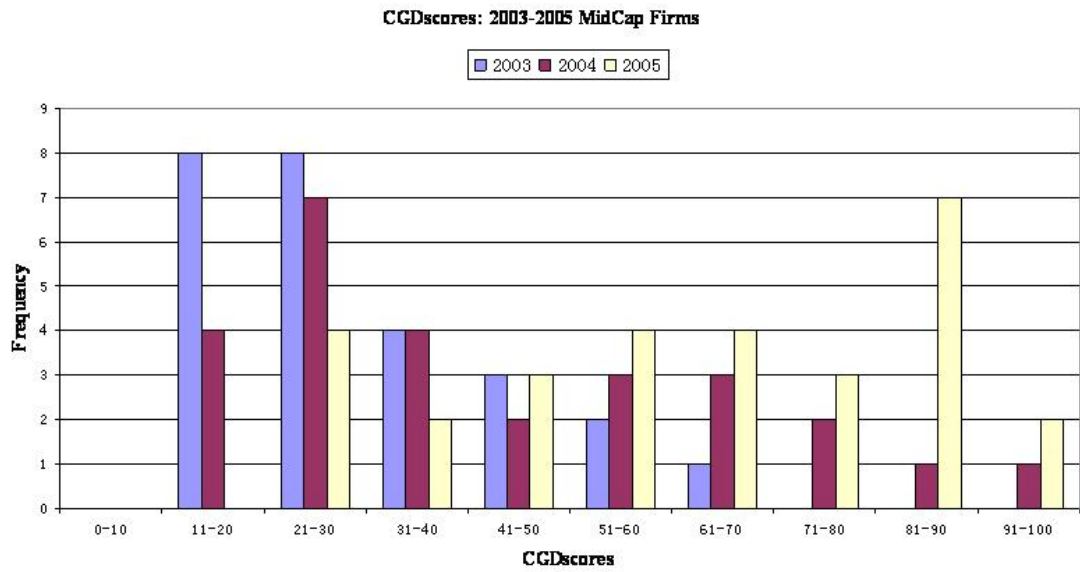
**Figure A1.3 Frequency distribution of  $q$  for SmallCap firms, 2003-2005**



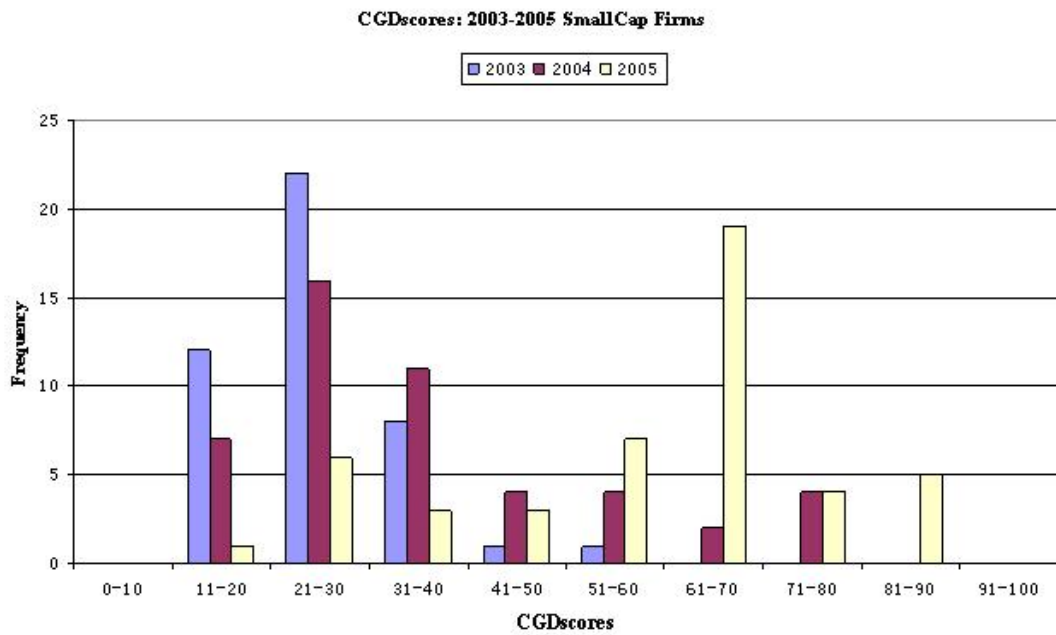
**Figure A2.1 Frequency distribution of CGDscores for LargeCap firms, 2003-2005**



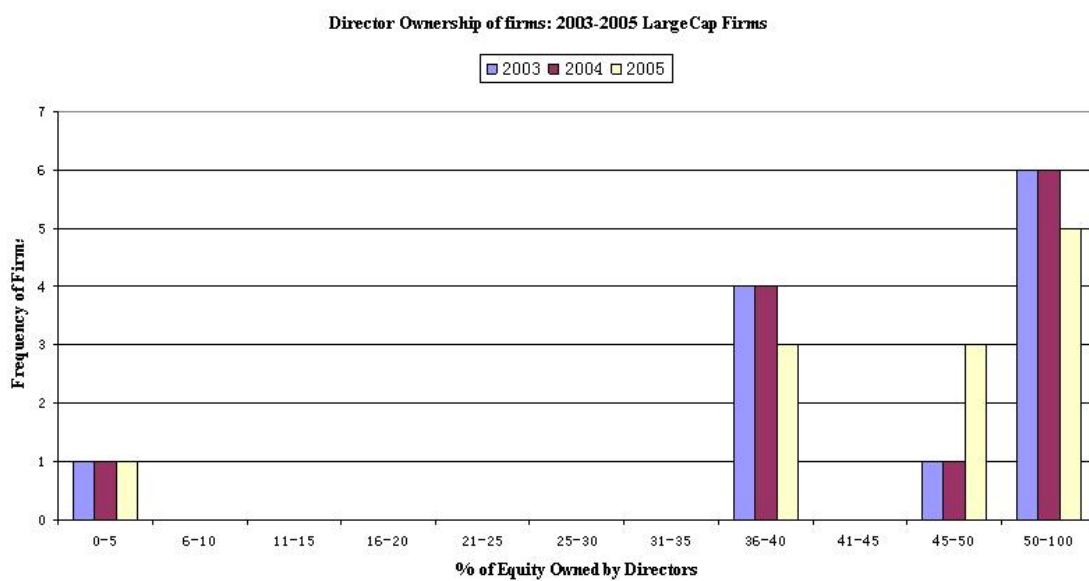
**Figure A2.2 Frequency distribution of CGDscores for MidCap firms, 2003-2005**



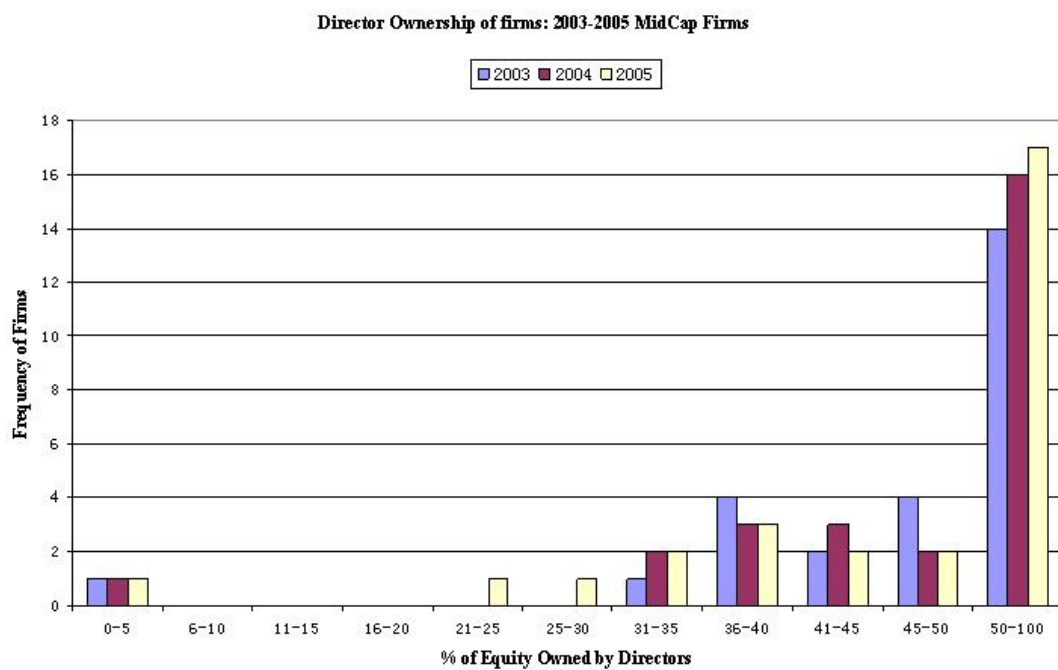
**Figure A2.3 Frequency distribution of CGDscores for SmallCap firms, 2003-2005**



**Figure A3.1 Frequency distribution of Dir%Own for LargeCap firms, 2003-2005**

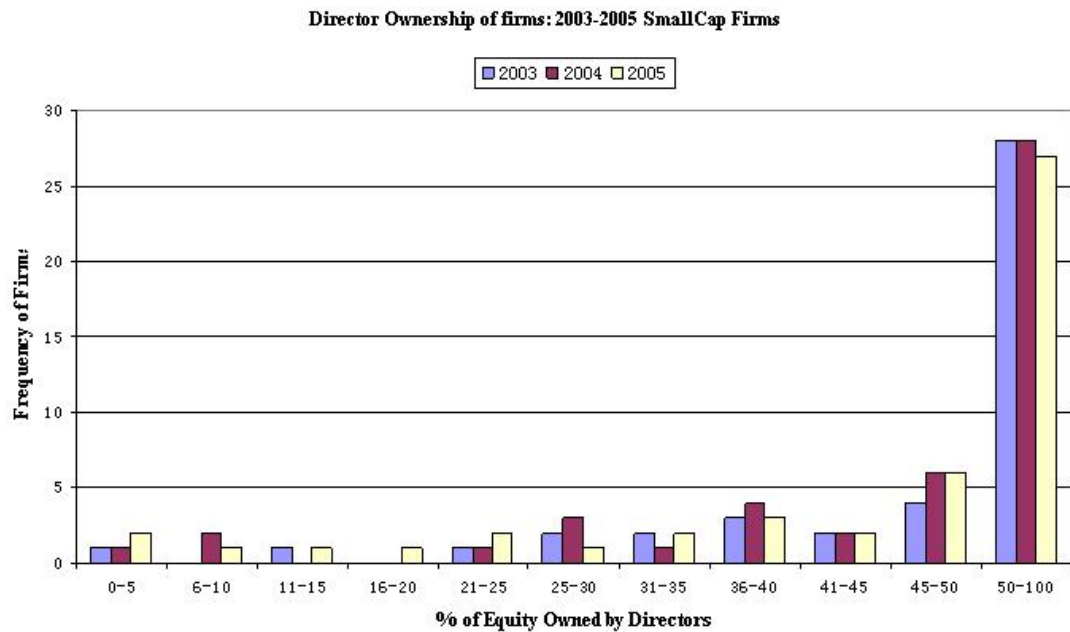


**Figure A3.2 Frequency distribution of Dir%Own for MidCap firms, 2003-2005**

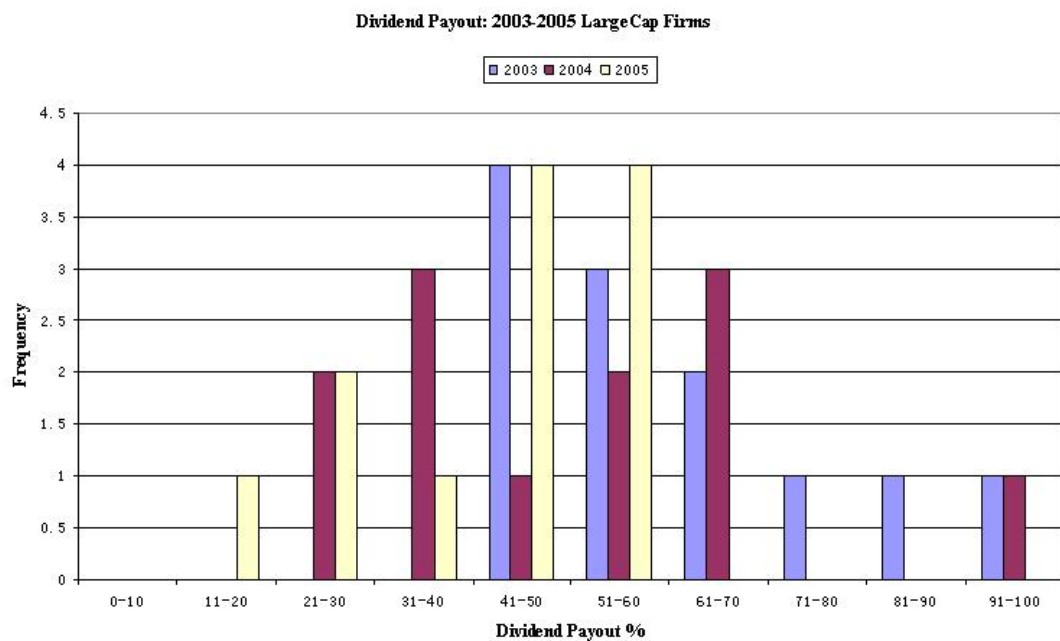




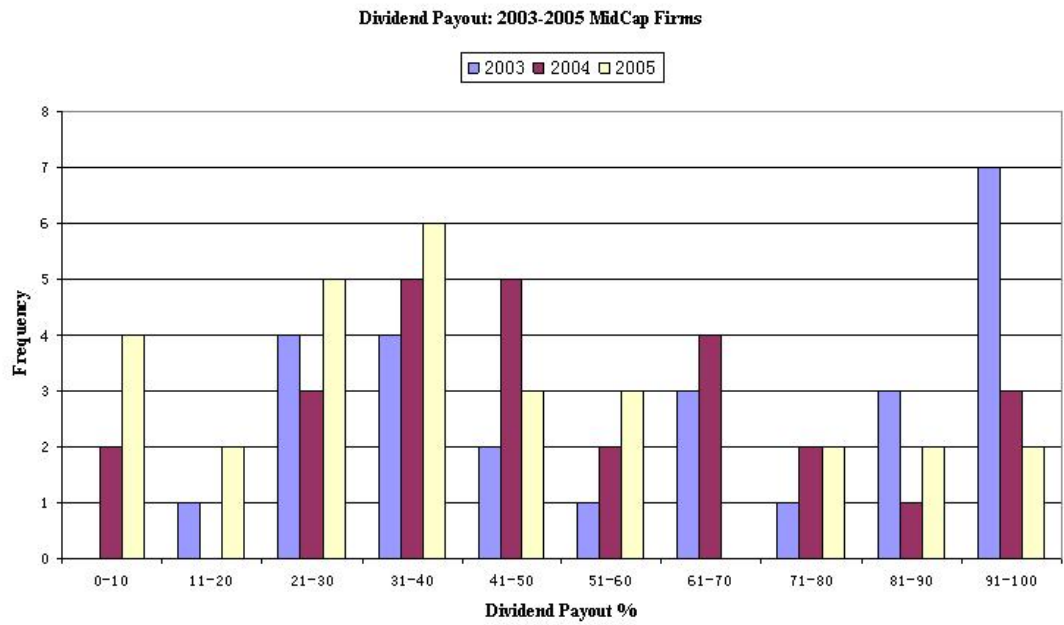
**Figure A3.3 Frequency distribution of Dir%Own for SmallCap firms, 2003-2005**



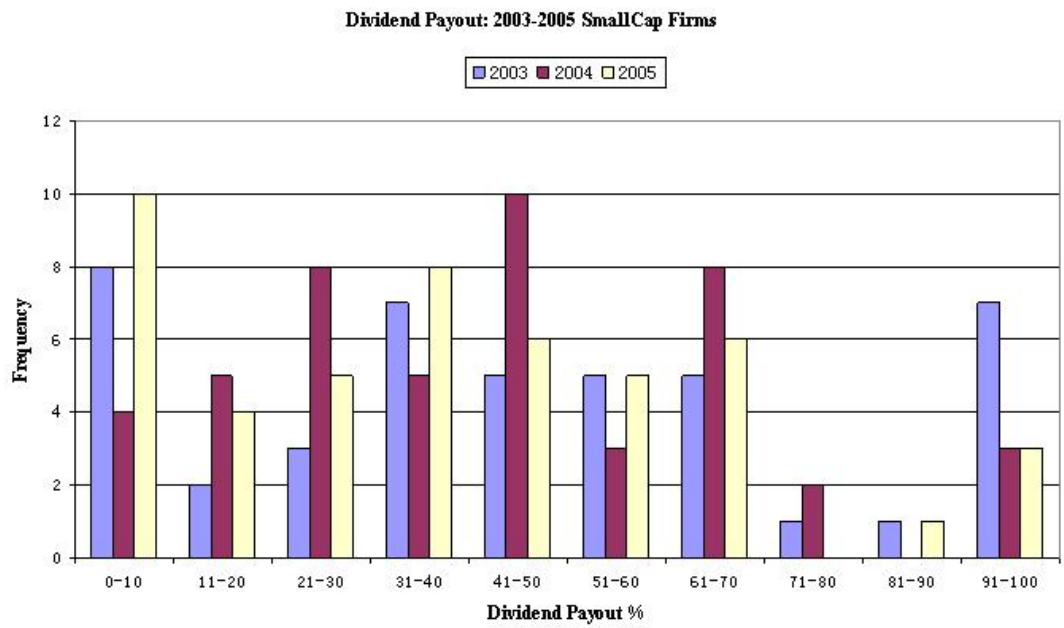
**Figure A4.1 Frequency distribution of DivPay for LargeCap firms, 2003-2005**



**Figure A4.2 Frequency distribution of DivPay for MidCap firms, 2003-2005**



**Figure A4.3 Frequency distribution of DivPay for SmallCap firms, 2003-2005**



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